



# Delaware's Competition

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# **Delaware's Competition**

Mark J. Roe

October 30, 2002



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*One of corporate law's enduring issues has been the extent to which state-to-state competitive pressures on Delaware make for a race to the top or the bottom. States, or at least some of them, compete with their corporate law to get corporate tax revenue and ancillary benefits. Delaware has "won" that race, with the overwhelming number of American large corporations chartering there. Here I argue that this long-standing debate is misconceived. Delaware's chief competitive pressure comes not from other states but from the federal government. When the issue is big, the federal government takes the issue or threatens to do so, or Delaware players are conscious that if they mis-step, Federal authorities could step in. These possibilities of ouster, threat, and consciousness have conditioned Delaware's behavior. This reconception a) explains corporate law developments and data that neither theory of state competition can explain well, b) fits several developments in takeover law, going private transactions, and the rhetoric of corporate governance in Delaware, and c) can be detected in corporate law-making in Washington and Wilmington from the very beginning in the early 20<sup>th</sup> century "origins" of Delaware's dominance right up through last summer's Sarbanes-Oxley corporate governance law and the corporate governance failure in Enron and WorldCom.*

*This analysis upsets the long-standing analysis of state corporate law competition as a strong race (whether to the top or to the bottom) because when a corporate issue is important, the federal government takes it over, or threatens to do so, or Delaware fears federal action. As such, we cannot tell whether Delaware, if it indeed raced to the top, did so because of the looming federal "threat". Nor can we tell whether Delaware, if it raced to the bottom, a) did so because national politics meant that, had they taken the locally efficient path, Congress, subject to wider pressures than is Delaware, would have taken the issue away, or b) would have instead raced to the top on other, more important issues that directly affected the mechanisms of a race to the top, had the states fully controlled them. Too many of the truly important decisions, the ones that could affect capital costs—the mechanism driving the race-the-top theory—are taken away from Delaware or are at risk of removal or the Delaware actors know could be taken away if they seriously damaged the national economy or riled powerful interests. That is not to say that what happens at the state level in corporate law is trivial, but that the results are ambiguous in terms of the race debate. If efficiency is the usual result, then the Federal vertical element could correspond to the strengths of other organizational structures (like separating proposals from ratification in decision-making, of the checks and balances in the M-form corporation). If inefficiency is the usual result, we do not know whether the states, if free to compete without a federal "veto" possibility, would have raced toward efficiency. When we add this "vertical," Federal-state competition atop the horizontal state competition in corporate law, the state race debate—one that has stretched across the 20<sup>th</sup> century from Brandeis to Cary and beyond—is rendered empirically and theoretically indeterminate.*



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# Delaware's Competition

Mark J. Roe\*

## INTRODUCTION

The nature of state competition for corporate charters—is it a race to the top or the bottom?—is one of corporate law's enduring corporate issues, one that goes back to the origins of the modern American corporation at the beginning of the 20<sup>th</sup> century and that persisted through the century in policy debates touched off by former heads of the SEC, Supreme Court opinions on state authority in corporate law, and continuing important academic analyses. Even today, as I write, new data is brought forth to support the proposition that the race is to the top,<sup>1</sup> or the bottom,<sup>2</sup> and political authorities, judges and commentators wonder whether the crises and scandals at Enron and WorldCom were produced by a race to the bottom, or could now be corrected by a race to the top.

Here I argue that this debate is misconceived, and badly so. Whether or not the states are racing,<sup>3</sup> and whether they are racing to the top,<sup>4</sup> or the bottom,<sup>5</sup> we live in a Federal system, and the Federal government can, and often does, take over issues of national economic importance. The very issues that are most likely to move into the Federal arena—securities trading during a Depression, takeovers in the 1980s, corporate governance today after a series of scandals—are the issues that could affect firm value so strongly that they'd be central to state-to-state competition. Yet these issues—the most fundamental aspects of corporate governance—are the very ones that induce the strongest possibility of Federal removal, and that risk of removal heavily

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\* Berg Professor of Corporate Law, Harvard Law School. Thanks for early conversations on the topic go to my colleagues Lucian Bebchuk, John Coates, Allen Ferrell, Jeffrey Gordon, Howell Jackson, Reinier Kraakman, Mark Ramseyer, and Guhan Subramanian.

<sup>1</sup> Robert Daines, *Does Delaware Incorporation Improve Firm Value?* 62 J. FIN. ECON. 525 (2001) (Delaware law enhances shareholder value by as much as 5% of the value of the firm).

<sup>2</sup> Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. \_\_ (forthcoming, 2002) (answering the question from the paper's title: no).

<sup>3</sup> Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. \_\_ (forthcoming, 2002) (states do not in fact compete; Delaware has a monopoly).

<sup>4</sup> Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. (1977); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 21 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NORTHWESTERN U.L. REV. 913 (1982).

<sup>5</sup> William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); *Liggett v. Lee*, 288 U.S. 517, 558 n.34 (1933) (Brandeis dissenting); Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933). Cf. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporation Law*, 65 TEXAS L. REV. 469 (1987) (Delaware bar as powerful interest group in shaping Delaware corporate law).



influences the Delaware result, even when Federal authorities in the end do not take the issue away. When it's important either a) the Federal authorities take it away, or b) they threaten to do so, or c) the Delaware players are conscious that a mis-step could induce Federal action.

Even when, as now, the Federal government does not threaten to take away Delaware's chartering business in its entirety—although it did seriously threaten to do so three times in the 20<sup>th</sup> century—Delaware players know that the Federal government can take away the corporate law-making function in whole or in part, and that it certainly has, on issues big and small. The Federal government takes away the issues—big and small—often enough so that Delaware players can never be oblivious to the possibility of being displaced. And, as such, we have never had, and we could never have, a true state-to-state race in corporate law.

Delaware has competition, even if it never looks over its shoulder at another state. Indeed, Delaware's competition in making corporate law comes not primarily from other states but, primarily, from the Federal government. It comes from Congress and the Securities and Exchange Commission, not California, Nevada, Ohio, or New York. It comes from the Second Circuit Court of Appeals in interpreting the expanse of the securities laws, not a new commercial court in another state.<sup>6</sup> Even if it had all the chartering business, Delaware need not get all (or at the limit, any) of the business of making corporate law.

This interaction then has deep implications for the race debate: First, there is no certainty to the mechanism that is said to produce a race to the top: Even if empirical evidence showed incontrovertibly that Delaware was racing to the top, we would not know whether state-to-state competition over charters produced the result, or whether the result came from the threat of federal ouster. And, if empirical evidence showed incontrovertibly that Delaware was racing to the bottom, we would not know whether Delaware reluctantly adopted inefficient law because it feared that congressional politics or errant judicial decisions or an out-of-control SEC would have ousted Delaware had it taken the efficient path.

Second, if Delaware law is in fact efficient, we need a better understanding of the mechanisms that would produce that efficiency: it cannot be pure state-to-state chartering competition because Delaware is heavily influenced by the potential for federalization. There may indeed be a "genius" to American corporate law,<sup>7</sup> and it may indeed involve regulatory competition, but if we have obtained optimal corporate law, or at least good corporate law—an open issue—the United States did so not based on state-to-state competition but on a structure akin to state proposal with the possibility of Federal veto. The *actual* American structure corresponds to organizational structures than a pure competitive market: its structure corresponds to the separation of proposal and ratification in management theory (i.e., states can act, subject to the possibility that another authority will change the result), and some variety of that kind of theory would be the basis for a theory of good corporate law-

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<sup>6</sup> And it comes from the New York Stock Exchange, which itself is often prodded to act by the SEC or Congress.

<sup>7</sup> The phrase is from Roberta Romano's highly respected book on the subject. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

making, if state corporate law is in fact on the whole efficient. More likely, corporate law, like other law, would have to be re-cast as an amalgam of efficiency, mistake, interest-group pressures, and happenstance. The result may be more ordinary than the racing engines corporate law scholars have designed, but more realistic.

\* \* \*

So the concept here is that corporate chartering is only one way to make the corporate law that governs the nation's largest corporations. A state might grant corporate charters, but Congress could make—and often has made—the rules. States like Delaware that want to provide a network for corporate-law decision-making—in its courts, legislature, and law firms—cannot look just to other states but must be conscious of how the federal government could react. The federal government can make the corporation's corporate law. And if it does so, it displaces state corporate law-making, even if the state retains the (at the limit, merely ministerial) authority to issue the charter. In securities law, and much else, this authority has passed from Delaware to the Federal government, and much that remains in Delaware is affected by the possibility of more passing from Delaware to Washington.

Understanding Washington's gravitational pull on Delaware's acts helps to resolve open issues in the Delaware race debate. Consider this: Delaware was a moderate in the 1980s antitakeover game. Other states passed severely antitakeover corporate law; Delaware did not. Delaware's moderation provided significant shareholder value, takeover theorists suppose. Yet, by end of the decade, Delaware's decisions were strongly antitakeover, to the point that some commentators considered the Delaware result close to the “just say no” defense that it had previously rejected for a “proportionality to the threat” standard. If Delaware raced to the top in 1980s (or resisted dropping to the bottom), one wonders why it stopped by 1990, or thereabouts. What changed? And the race-to-the-bottom theory has equally severe problems: if Delaware gets the chartering business principally by pandering to managers, one wonders why it took them nearly a decade to get there. The issues were obvious to the Delaware players. Other states were passing severe anti-takeover laws, while Delaware's legislature refused to do so at first, and then was moderate, while its court decisions zig-zagged until 1989 or so, with “proportional-to-the-threat” standards in *Unocal* and powerful anti-managerial auction rules in *Revlon*. Not only were the issues obvious and not only were the other states doing as managers asked them to, but the threat of re-chartering out of Delaware was not just “in the air.” By 1988, Martin Lipton's famous Memo to Clients—distributed to all who were interested, reported in the press, and surely read by the Delaware players—recommended to corporate America that the exodus from Delaware begin. Yet Delaware did not immediately go over to the antitakeover side in the 1980s.

Neither race theory does well here in explaining how Delaware's takeover rules developed. Yet takeovers are the most fundamental corporate law issue of the past quarter-century. Theories that cannot explain the most important phenomena they purport to cover need to be modified.

When we add the federal government to the picture, we get a much crisper picture. The Federal government was overall taking middle-of-the-road position on takeovers in the 1980s—with a very active pro-takeover SEC, a moderately

antitakeover Congress, and, for a time, a pro-takeover judiciary. Then the federal authorities left the field one-by-one at the end of the 1980s and the early 1990s. Before the Federal authorities left the field, the Delaware decisions zig-zagged, sought proportionality standards, and were sometimes pro-takeover. And the Delaware legislature passed, as is well-known, one of the most moderate of the antitakeover statutes, one with only mild bite. Then, after the Federal authorities left the field (judicial decisions turned around with Supreme Court's *CTS* decision, personnel changes at the SEC made it less pro-takeover, and Congress lost interest), Delaware decisions became more persistently pro-manager and more persistently anti-takeover.

With the vertical, Federal relationship in mind, we get a much better explanation than any other in existence, about why Delaware lagged the other states in producing anti-takeover law, and then became about as antitakeover as its state competitors: Delaware held off from becoming severely pro-managerial while Congress was mulling and the SEC was strongly pro-takeover. When Congress and the SEC receded, Delaware could move. The movement over time of Delaware's takeover law and the change over time in new powerful data on takeovers are both best explained by this fear-of-federalization sequence, but fit neither a pure race-to-the-top nor a pure race-to-the-bottom theory.

The hostile takeover is not the only corporate institution whose governing law can be better explained with Delaware-Washington interaction. Other major corporate events in the 20<sup>th</sup> century were also contests between state and federal authority, with federal authority usually winning, either directly via a new statute or regulation, or indirectly via inducing rules at the state or self-governing level. Delaware's famous decision that froze the raider T. Boone Pickens out of a target company self-tender for stock induced the SEC to replace Delaware's selective tender with Rule 14d-10, the SEC's all holders rule. Delaware's reticence in the face of a wave of dual-class recapitalizations (transactions that led public shareholders midstream to end up without any future right to vote) was reversed first by the SEC and then, when the SEC failed, by the stock exchanges under SEC prodding. Going private transactions of the 1970s were first welcomed in Delaware then heavily regulated when the SEC threatened preemption.

And the federal-state move is not just one from recent decades: The securities laws themselves were designed to displace what were perceived to be the most failed sector of state regulation. Even the earlier, beginning of the 20<sup>th</sup>-century origin of the Delaware-New Jersey race was a three-way contest among the federal government and the two states, with the federal government taking over, as we shall see, the most important issues from the states for direct federal regulation.

The recent wave of corporate governance failures led Congress to pass a new law that federalizes important elements of corporate governance that were previously state-controlled and self-regulatory. The state and self-regulatory mechanisms allowed by the states, having been perceived as failing, are displaced, and the Delaware actors are painfully aware that Sarbanes-Oxley partially federalizes many of their institutions.

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In Part I, I briefly outline current theory. In Part II I show the myriad mechanisms by which federal law-makers can, and do, set aside Delaware law. We

have a concept that the internal affairs of the corporation are to be left to state law, but this is only a tradition, one that is regularly dishonored, but frequently then “saved” by re-conceptualizing the federalized affair as “external” not internal, and therefore no longer appropriate for pure state regulation. We see how the mechanism of ouster could be via congressional action, SEC rule-making, judicial interpretation, or New York Stock Exchange listing requirements made under SEC influence.

In Part III, I show that federal authority regularly threatens to displace the states and regularly does replace state rules: federal incorporation was seriously on the agenda in three decades in the 20<sup>th</sup> century. Federal authority has taken over securities trading, shareholder voting—arguably the single most important internal affair of the corporation—and most of the mechanics of accounting in public firms. Controversies on going private, dual-class recapitalization, the range of fiduciary duties (in the 1960s and 1970s), and takeovers (in the 1980s) all threatened to go federal or actually did go federal. Recently, two lesser federal corporate statutes simply displaced all state laws to the contrary, not even bothering to pursue the old deference to parallel regulation. And one major statute—the Sarbanes-Oxley Act of 2002—prescribes corporate rules that cannot be considered anything other than “internal affairs” of all large American corporations. Even today Delaware’s corporate law-making business is in federal jeopardy.

In Part IV, I address the theoretical implications. The United States has not had, and cannot have, a pure race to the top. Anything important enough to affect the key mechanisms of the race to the top—law that raises or lowers capital costs—is important enough to attract federal attention. Often over the 20<sup>th</sup> century decisions moved from Delaware to Washington. And when the issue did not attract explicit action from Washington, what Delaware did was often affected by what Washington was thinking about doing. Even if evidence showed beyond doubt that actual Delaware law raced the top, we cannot tell whether it raced there because of fear of federalization or because of interstate competition. The race to the bottom theory is equally indeterminate. If the states clearly produced defective corporate law, we cannot tell for sure whether they did so because of mechanisms intrinsic to the race, or because the federal overlay of congressional politics, inattention and happenstance induced the inferior result.

And then I conclude: the mechanisms that would make for a pure race (to the top or the bottom) are absent in a true federal system, such as the United States. The idea here is not just theoretical: hardly a decade has gone by without the federal government considering taking over some major corporate issue from the states, suggesting that Delaware’s strongest competitor has been, and probably still is, Washington. This renders the mechanisms of the race impossible or indeterminate. If the corporate issue is important, it becomes a federal issue, not a purely state-law Delaware issue. That result is as one should expect, and the race analysis must yield to a wider perspective on what makes for corporate law.

## I. CURRENT THEORY

We have a long, important debate, one that has engaged several of the best minds in corporate scholarship and corporate activism, from Brandeis to Cary, on whether state competition pushes state corporation law to the top (in terms of efficiency for shareholders) or the bottom (in terms of favoring managers over shareholders). A brief review of that debate is in order before we cordon it off and minimize its overall importance.

### A. Delaware's Advantages

Delaware is a small state, and its advantages in any race derive largely from its small size. Revenues from the corporate franchise tax are a large fraction of the state's budget, 15-20%, amounting to several hundred million dollars annually, and on a per capita basis turn out to be a noticeable sum of money for each Delaware resident. The corporate bar can influence the legislature (and perhaps the judiciary), in ways that larger states would ignore. Local interest group pressures from, say, labor unions and corporate management are weak, because the state is not heavily industrialized. The average citizen has a stake in keeping the revenues but not much of a stake in what the rules actually are. This makes for something akin to organized private law-making among the corporate players.

Delaware also has a specialized, highly regarded judiciary, operating without a jury. The judges take pride in keeping up with business trends, on having good business sense, on knowing their own limits, and on reacting quickly as professionals. The body of judicial precedent and knowledge establishes a network, one that would be costly for a single player to leave.<sup>8</sup>

### B. Racing to the Bottom

The race to the bottom was nicely articulated early on by Justice Brandeis in *Liggett v. Lee*:

Lesser States, eager for revenue derived from that traffic in charters had removed safeguards from their own incorporation laws.... The race was not one of diligence but of laxity.... [T]he great industrial States yielded in order not to lose wholly the prospect of the revenue and control incident to domestic incorporation.<sup>9</sup>

And in modern times, the perspective was picked up by William Cary, articulating the race to the bottom view he developed while chair of the SEC:

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<sup>8</sup> See generally Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713 (1997); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

<sup>9</sup> 288 U.S. 517, 557-60 (1932).

[T]he first step [for improving corporate law] is to escape from the present predicament *in which a pygmy* among the 50 states prescribes, interprets, and indeed *denigrates national corporate policy* as an incentive to encourage incorporation within its borders.  
 ...<sup>10</sup>

Delaware, the race-to-the-bottom theory runs, provides a corporate law that panders to managers, often at the expense of shareholders. Shareholders cannot make the reincorporation decision alone, as corporate law requires that they act only after the board—the managers—recommends reincorporation.<sup>11</sup> The first actor in the reincorporation decision is the board, and the states give the managers whatever they want. Shareholders are too dispersed in the public corporation to control the situation, and they usually just rubber-stamp managers' recommendations, if they ever actually get to decide. The standard collective action problem makes it not worthwhile for the shareholders to organize and second-guess managers on a reincorporation decision.

More nuanced analyses point out that Delaware has a network advantage, and that network advantage gives shareholders a "plus" which can then be spent on pro-managerial substantive rules.<sup>12</sup> Or the reincorporation decision comes in a "good news" package: the firm is expanding and makes a big stock offering at the time it reincorporates, or it considers a good news merger. Shareholders, happy with the overall result, approve the set of board proposals.<sup>13</sup> Empirical analyses show that much recent reincorporation involves movement from states—like California—that are seen as tough pro-shareholder states, into Delaware,<sup>14</sup> and that states that have the most anti-takeover, pro-manager rules retain more corporate charters than states that are less enthusiastic in protecting managers from takeovers.<sup>15</sup>

### C. Racing to the Top

The process of pandering to managers can go only so far. States that systematically hurt a firm's operations would raise their firm's cost of capital, as

<sup>10</sup> Cary, *supra* note 5, at 701 (emphasis supplied).

<sup>11</sup> E.g., Del. Gen'l Corp. L. §§ 241, 251.

<sup>12</sup> Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Bebchuk, Cohen & Ferrell, *supra* note 2.

<sup>13</sup> Bundling is harder to do after the 1992 SEC proxy amendments, but still possible. Note again that federal authority, not state authority, made issue-bundling harder for managers.

<sup>14</sup> Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2001).

<sup>15</sup> Bebchuk, Cohen & Ferrell, *supra* note 2. Kahan & Kamar recently concluded that no other state is racing against Delaware in corporate chartering. Kahan & Kamar, *supra* note 3. No one tries to get the corporate revenues, even the other small states, they argue. This is a major contribution to understanding the race and its limits. However, in my view, this fact, even if true fails to end the race analysis. The race could be one of contestable markets: if Delaware riles managers (in the bottom view) or hurts firms badly (in the top view), corporate players will rush to Rhode Island or North Dakota to convince them to create a new corporate law. Even if these states are not now racing, the corporate players who would benefit from ending Delaware's dominance would show them what to do. That's how it happened for New Jersey and then Delaware. This contestable markets structure gives the dominant state room to maneuver in the short run, but a big error could induce a mass and irreversible exodus, as New Jersey experienced a century ago.

eventually capital markets participants understand that the firm is weaker, earns less, and is not as strong as another firm from another state. Over the long-run this damage to the firms' capital-raising capacity will take its toll: the firms' managers will realize that in the long-run they are weakening the firm by reincorporating in that bad-law state, the pot for all to split (shareholders and managers) has to diminish in size and that cost would motivate the players to reincorporate elsewhere. At the limit the firm could disappear, either in bankruptcy or via a takeover from a stronger firm in a neighboring state with better corporate law.<sup>16</sup> Bad corporate law might persist, but the firms incorporated under that bad law would, one way or another, not.

This or that corporate rule might in isolation not seem to be pro-shareholder—a rule, say, limiting shareholders right to sue. But not all rights and remedies are efficient. Some diminish the capacity of the organization to act and, the theory runs, those that diminish the capacity to act effectively tend to be discarded, and those that tend to improve the organization for shareholders tend to persist.

Delaware's efficiencies are often proclaimed, and data sometimes produced to support that view.<sup>17</sup>

## II. THE FEDERAL BEHEMOTH: THEORY AND MEANS

Federal authorities are not playing the same game, and are subject to differing motivations and pressures. That is, in both the top and the bottom race, the states are looking to gain revenue from the chartering business. Other considerations might come into play—satisfying local interest groups, for example—but the franchise tax is a key motivator (up in one theory, down in the other). But for Federal authorities this revenue is just too small a part of the Federal budget. Other considerations come into play for the Federal authorities: management of the economy overall on the high end, with concomitant goals of protecting investors and consumers. On the low-end, Federal authorities are subject to interest-group pressures, including pressures from groups that have more clout in Washington than in any one state. Some Federal authorities would be interested in how the issue plays out in the media, or where campaign contributions could be garnered. And most corporate law issues are likely to be lower down on the federal agenda than they are on Delaware's agenda, so Federal authorities, with limited attention, might not give the corporate issue enough attention. And when they give it enough attention, even high-end, public-regarding attention, a Federal rule could squelch variety too quickly, foreclosing a dispersed polity from gaining new information that would over time improve corporate law.

The point here is not the Federal authorities are systematically better or worse than the states, but that what motivates and pressures the Federal authorities differs from what motivates the states in general and Delaware in particular. They're not necessarily playing the same chartering game, and they may not even be moving to the same goal.

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<sup>16</sup> Winter, *supra* note 4.

<sup>17</sup> ROMANO, *supra* note 4; Daines, *supra* note 1.

### A. The Internal Affairs Doctrine

If one were to only read the doctrinal surface, one might think there was a sharp distinction between state and federal corporate law-making during the 20<sup>th</sup> century. States govern the internal affairs of the corporation, while the federal authorities, namely the SEC, govern the external trading in the firm's securities. The structure is sometimes stated in federal decisions,<sup>18</sup> and more often proclaimed by Delaware players as proper, traditional, and in need of deep respect. Even the Enron debacle, said the chief justice of the Delaware Supreme Court only a few months ago,<sup>19</sup> would be better dealt with at the state level. Whether he was right or wrong, just three months after his speech, Congress passed the Sarbanes-Oxley Law of 2002, a sweeping reconstruction of corporate governance in large firms in the United States, a matter that might have been thought to be one of the internal affairs of the corporation.

The difficulty with the internal affairs doctrine as permitting a state-to-state race is that it is just an understanding not, say, a crisp constitutional rule of how corporate regulation must be allocated. And it's an understanding that is breached much more often than Delaware might like. It is breached formally, as when Federal authorities just go ahead and regulate internal affairs, as the federal authorities did in Sarbanes-Oxley and related initiatives, mandating board structures and authority. And it is breached informally, as Federal authorities, in the guise of regulating, say, disclosure to securities markets, effectively control the underlying governance structure of the corporation, the very internal affairs that state law is said to govern.

Indeed, all of corporate law could be federal law. This is an obvious point, but needs to be recalled. The interstate commerce authority means that the internal affairs doctrine can be no more than an understanding, not a sharp limit on Federal law-making. Indeed, from time-to-time there is serious talk of federal chartering of firms in interstate commerce, a proposal that although not serious today at the beginning of the 21<sup>st</sup> century, arose three times in the 20<sup>th</sup> century (in the 1900s-1910s, the 1930s, and the 1970s) as serious proposals.<sup>20</sup> In banking, the federal government gave itself chartering authority, and when it wanted state-chartered banks to comply with federal policy, it required them to do so.<sup>21</sup> Congress, were it so inclined, could do so for America's large firms.

But the issue of federal incorporation fades, as Congress moves on to other agenda items. And the incorporation decisions are left to the states. The last serious effort at federal incorporation passed by the end of the 1970's. Yet it still is on the minds of Delaware players (who understand the fragility of their franchise and chafe under the criticisms they endured a quarter-century ago).

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<sup>18</sup> CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

<sup>19</sup> E. Norman Veasey, The Role of the Delaware Courts in United States Business Litigation, ALI-ABA Advanced course of Study, April 11, 2002, at 3. E. Norman Veasey is Delaware's Chief Justice.

<sup>20</sup> See *infra* Part III.B.

<sup>21</sup> FDIC Act § \_\_\_\_.



Full federal incorporation is not the only means by which Federal authorities can displace state law. Federal authorities—Congress, the SEC, the courts—can take individual items up for federal action. And, as we shall see in Part IV, one or the other regularly has. When a big issue arises, either the courts (think: the burgeoning fraud liability of 1960s, threatening to turn, and actually turning many, state fiduciary duties into federal causes of action); or the SEC (think of the going private activity of the 1960s and 1970s), or Congress (think: executive compensation in the 1990s finding itself regulated via the internal revenue code or federal corporate governance mandates via Sarbanes-Oxley and associated initiatives) can take the issue or can consider taking the specific issue, pushing Delaware into a corner. Federal incorporation would be the clearest ouster of state law, but there are so many other ways by which federal authorities can take the production of corporate law away from the states.

They can, and they often have.

## B. Who are the Federal Authorities?

Just to be explicit, we have three fundamental federal authorities, each of which can make and threaten to make corporate law.

1. *Congress, of course.* Consider, for example, corporate voting, perhaps the core “internal affair” of the corporation. Lawyers who work on corporate voting know that they are operating primarily not under state law, but under Federal proxy law, section 14 of 1934 Act. The 1934 Act effectively has made many voting rules federal rules, not state rules, and it could take away the rest were the SEC so inclined. Or governance issues like executive compensation can be controlled (or hoped to be controlled) via tax law. Sarbanes-Oxley shows how Congress, when it so wishes, can micro-manage corporate law: mandating managerial duties, allocating authority inside the corporation, and so on. If it wishes, it can swoop in and take over any major aspect of corporate law, as it often has, and more often has threatened to.

2. *And the SEC.* The SEC has broad authority to regulate securities trading. Much securities regulation can impinge upon, or over-turn, state corporate governance rules. Consider one explicit one, and one subtle one. When Delaware validated a corporation offering to buy back stock from its stockholders (a transaction internal to the corporation, just between its shareholders and the firm), and excluded one large shareholder—the raider, the SEC responded with its “all holders rule,” obliterating the state rule.<sup>22</sup> Or consider who runs the corporation: Delaware says straight out that management of Delaware corporations is vested in the board of directors. No exceptions for the ordinary business of the corporation: it’s the board, not the shareholders who run the operation. And hence, a proxy proposal to direct the board to do an ordinary management act is impermissible under Delaware law. But now, in a subtle evolution, the SEC is mandating that managers include “precatory” resolutions from shareholders on such items in the company’s annual proxy solicitation. “Voice” is not direction and the structure leaves boards formally empowered to ignore their

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<sup>22</sup> Compare *Unocal Corp. v. Mesa Petroleum Co.*, 193 A.2d 946 (Del. 1985), with 1934 Act Rule § 14d-10.

shareholders, but voice changes outcomes and it is a step closer to power, a subtle change in the internal authority state law had set up.

3. *And the courts.* Whether a shareholder can sue can obviously determine corporate law. Perhaps to a lawyer it is the most basic right of the shareholder. And as is well-known to securities lawyers, the federal courts opened up a huge area of liability under the securities laws in the 1960s and 1970s, implying private rights of action in a way that was substantially turning state fiduciary rules into federal law. The fact that the Supreme Court cut back on the doctrinal bases for the expansion by the late 1970s, does not mean that this a) was not real and a constraint on state behavior, and b) was an aberration that could not happen again via other means.

4. *And the stock exchanges.* The New York Stock Exchange makes many rules that govern the largest American corporation, rules that affect corporate internal affairs, the stuff of ordinary state law-making. The rules now regulate voting disparities, i.e., whether a one-share, one-vote rule would apply, or whether voting strength is variable. One might think that the NYSE is really a fully private self-regulatory organization, but that is not so. It's susceptible to a great deal of informal (and formal) influence from SEC. Even when the SEC lacks informal authority, it often induces the NYSE to act.

### **III. DELAWARE'S MAIN COMPETITOR IN MAKING CORPORATE LAW: WASHINGTON, D.C.**

#### **A. Can Displace**

So, notwithstanding that fragile internal affairs doctrine, the Federal government can displace state corporate law, and rather easily. Legislation can preempt state corporate law, explicitly or implicitly, and it has. Judicial interpretation of open-ended legislation can occupy the field, leaving no room for state corporate law, as it has on a few sharp, and very important occasions. Open-ended delegations to the SEC can give the SEC the power to muscle aside the states from a regulatory area, and they have been. And the securities laws themselves can directly pull away corporate law issues from the states, as it has for voting and more. As the leading securities regulation analyst of his time said: "I think it's not too much to say that [key provisions of the 1934] Exchange Act ... [are] at least second cousin, if not first cousin, to federal incorporation in substance, not in form."<sup>23</sup>

These federal forays could affect the state incorporation business even without direct federal preemption: That is, their most important effect here is that a) corporate law could be made elsewhere than in the states, and b) the states, especially Delaware, are deeply affected by the possibility of Federal law-making. But there's even more. Even if Delaware is fully unconscious of the prospect of Federal law-making, Federal law-making can deeply affect state-to-state incorporations: Imagine that the Federal government leveled the field by determining all important issues. If so, then there

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<sup>23</sup> Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUSINESS LAWYER 27, 29-30 (1969).

would be no advantage to incorporating in Delaware. Delaware would lose excess tax revenues from incorporation because then the race would be to provide the lowest franchise tax (since the states could not vary core corporate law any more than they can now vary securities law or the federal corporate tax). Delaware would become less important and Delaware corporate players peripheral. When a corporate issue moves into the federal arena there is that much less for states to race about, whether to the top or the bottom. Every time federal authorities take an issue over, Delaware becomes less important as the locus of corporate decision-making. Its power to charge a high franchise fee diminishes. And the psychological and other benefits that local players get (those Delaware law firms, those important chancery court judges) become less lucrative and less psychologically important, because the locus of active decision-making lies elsewhere.

## B. Can Inspire Fear

Delaware players have reason to fear that if they mis-step, they will lose the law-making business. They know that the federal authorities, even if not breathing down the Delaware corporate necks at every moment, could act. If Delaware does something badly wrong that instigates public policy-makers in Congress or the SEC to act, Delaware will lose the business. If Delaware does something that deeply offends an interest group with clout in Congress, Delaware could lose the business. Even on an issue where the Federal authorities are thus far silent, Delaware has reason to be looking over its shoulder at Washington as much as, or more, as at any other state.

1. *Federal incorporation.* And Delaware has reason to fear that everything could be federalized. Not now, in the present environment, but if Delaware slipped badly. Look at the history of federal incorporation, which was seriously on the Washington policy agenda in three decades of the 20<sup>th</sup> century.<sup>24</sup> In the century's first decade:

The U.S. Industrial Commission [in Washington] lodged a thinly veiled complaint against New Jersey, complaining that [a state's] corporate regulation couldn't stick [if tough] because a tough state would be displaced by another state like New Jersey.<sup>25</sup>

Presidents Roosevelt, Taft and Wilson each sought mandatory federal incorporation during that era.<sup>26</sup> And the prospect of federal chartering of corporation engaged in interstate commerce seriously arose again in the 1930's. The Presidency,<sup>27</sup> the Congress in general,<sup>28</sup> and the head of Congressional Temporary National Committee

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<sup>24</sup> The serious proposals to federalize corporate law are described and sourced in Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89 (1972).

<sup>25</sup> Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1919*, 49 J. ECON. HIST. 677, 686 (1989).

<sup>26</sup> LOUIS LOSS, *SECURITIES REGULATION* 108 (2d ed. 1961).

<sup>27</sup> Allen D. Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover Regulation*, 47 OHIO ST. L.J. 1037, 1051 n.69 (1986), citing Letter from the President of the United States to the Chairman of the Senate Banking and Currency Committee (Jan. 25, 1934).

<sup>28</sup> Roper & Dickerson Report, S. Comm. Print, 73d Cong. 2d Sess. 4 (1934), reprinted in 4 LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934, item 16, at 4; Temporary National

in particular, all pushed the idea,<sup>29</sup> and the SEC<sup>30</sup> seriously studied it. Consider this summary of the New Deal view:

Roosevelt committed himself to the long-held populist and progressive goal of superseding lax state corporation laws with more stringent federal standards. His security policy was an attempt to remedy the weaknesses in the four bodies of state and private rules then in effect, which cumulatively failed to minimize fraud or unfairness in the initial sale of corporate securities.

Most fundamental of the rules Roosevelt sought to supersede were the state corporation laws. Originally the state corporate statutes had been restrictive, limiting, among other things, the amount of capital a business firm could raise. But [then the states raced to the bottom].<sup>31</sup>

So the securities laws were passed, partly in the view that state law failed to handle some important corporate problems. And later during the 1930s, the core legislation coming from Congress's main economic committee during the depression sought to finish the job begun with the securities laws, by "completing the federalization of business law."<sup>32</sup> Senator O'Mahoney said: that "[s]ince ... national commerce is carried on by national corporations, it should be the Federal Government and not the State governments which ... describe and outline the powers of the corporations ... ."<sup>33</sup> The Senator would have had federal rules determine fiduciary duties, determine voting rights, had shareholders vote on executive compensation, judicial review of stock issuances, and set up alternative proxy mechanisms to the management controlled proxy machinery.<sup>34</sup> If that were not enough to end Delaware's franchise, the bill would have required that the place of incorporation be the place of the company's main business,<sup>35</sup> a requirement that would have ended Delaware's race to anywhere.

And then in the 1970s, William Cary, by-then a former chair of the SEC, brought the issue back, as it turned into a American Bar Association study: Cary said that it was time to end Delaware's influence on corporate law. Either corporate law should be national for firms in interstate commerce, or federal rules should establish a minimal set of standards that would cover all corporations in the United States.

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Economic Committee, *Final Report and Recommendations*, Sen. Doc. No. 35, 77<sup>th</sup> Cong., 1st Sess. 24 (1941) (the TNEC actually came down on the side of national standards, short of national incorporation).

<sup>29</sup> The head of Congressional committee was Senator O'Mahoney. He describes his efforts, which continued through the Depression, World War II, and its aftermath, in an article entitled with his goal. Joseph G. O'Mahoney, *Federal Charters to Save Free Enterprise*, 1949 WISC. L. REV. 407, 415 (1949).

<sup>30</sup> LOSS, *supra* note 26, at 110 n.17.

<sup>31</sup> JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 42 (1982).

<sup>32</sup> Boyer, *supra* note 27, at 1052. See O'Mahoney, *supra* note 29.

<sup>33</sup> *Hearings on S.10 before the Subcomm. of the Senate Comm. On the Judiciary*, 74th Cong., 1st Sess. 270-71 (1937). And, said the Senator, "if a corporation is engaged in interstate commerce ... the representatives of the people of the United States [ought to] defin[e] ... its power." *Id.* at 441.

<sup>34</sup> Boyer, *supra* note 27, at 1053.

<sup>35</sup> *Id.* at 1052. This would roughly have mapped onto Europe's "real seat" doctrine.

2. *Federal minimal standards.* William Cary's proposal—coming in one of the most cited law review articles—side-stepped federal incorporation, with a proposal for, in lieu of a national corporate law, a set of national minimum national corporate standards,<sup>36</sup> an idea that Congress then picked up with proposals to mandate independent directors, require key board committees to have a majority of independent directors, and to have shareholders vote on more matters.<sup>37</sup> (These proposals, radical at the time, eventually became the norm, some by accretion, some by practice, some by stock exchange rules, some by SEC rules.)

Consider Cary's influential article alone. Little could threaten Delaware more than to read the plan of a then-recent Chair of the SEC for federal standards of corporate action, dealing with Delaware not by praising its expert and savvy judges but by dismissing it as a pygmy.<sup>38</sup> Corporate law must be improved, said Cary, and

The first step is to escape from the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders<sup>39</sup>

These were not the easy-to-dismiss musings of a frustrated SEC commissioner. They were not musings lacking real world impact. The American Bar Association quickly took the proposal from the article—considered to be “the most influential piece ever published by the Yale Law Journal”<sup>40</sup> as the basis for study and a Business Lawyer-ABA symposium on federalizing corporate law, a real-world indicator the Delaware players would surely not ignore.<sup>41</sup>

If Cary's proposal for federal minimal standards once hit Delaware hard, that would be enough to put down a brick or two in the foundation of the argument I am building—that Delaware's principal competitor is Washington. But there is more. The article still stings Delaware players, 25 years later. I hear them—today, in 2002—arguing against Cary's mistakes and how misguided it would have been—and would be today (more of that soon)—to federalize any key part of corporate law. I can say from conversations with sitting Delaware judges that they are aware of the possibility of federalization, and are still chafing 25 years later under the rhetorical whipping from Cary's attack.

3. *Consciousness.* We obviously cannot psycho-analyze the Delaware players to see if they're consciously weighing the possibility of federal ouster or otherwise reacting to federal pressure. But we can from time-to-time detect their consciousness of the federal possibilities.

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<sup>36</sup> For the Congressional possibilities, see *Hearings on Corporate Rights and Responsibilities Before the Senate Comm. On Commerce*, 94<sup>th</sup> Cong., 2d Sess. (1976).

<sup>37</sup> Cf. Fischel, *supra* note 4, at 916.

<sup>38</sup> Cary, *supra* note 5, at 701.

<sup>39</sup> *Id.* at 696, 700-03.

<sup>40</sup> Ralph K. Winter, *Foreword to THE GENIUS OF AMERICAN CORPORATE LAW* xi (1993).

<sup>41</sup> Richard W. Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUSINESS LAWYER 991 (1976). Social responsibility activists wanted federalization for other reasons, beyond those that motivated Cary and the ABA study. RALPH NADER ET AL., CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976).

Consider how one critical takeover decision began: This is an issue of national importance, said the judge first. True, this could be simple breast-beating. Or it could be Delaware visibly assessing whether it had room to maneuver. Was it constrained by the federal position? With the eyes of the federal authorities upon it, was Delaware really free to maneuver? The latter consideration is made much more plausible by the Court's statement a few pages later that although the SEC intervened, it had split 3-2 on whether to seek to intervene. With the interested Federal authority divided, Delaware could act. The implication is that if the federal view were cohesive, Delaware would have more trouble exercising its discretion.

There are revealing speeches. During the takeover controversy, one Delaware justice commented that Congress was not doing much anymore to control takeovers right then, implying that the Delaware judiciary had increasing room to maneuver.<sup>42</sup> And even when Delaware players did not have their eye on what Congress was doing, they had reason to know that media criticism could induce federal action.<sup>43</sup>

The Delaware consideration might not just be fear. It could be respect: As the Delaware Chancery court said only a few years ago: "An administrative agency—the Securities and Exchange Commission—has a technical staff, is able to hold public hearings, and can, thus, receive wide and expert input."<sup>44</sup> Either way, Delaware is looking to the Federal authorities as one basis for decision-making.

Consider now, more carefully, a recent speech from Delaware Chief Justice. First off, he recognizes the paper-thin protection that the internal affairs doctrine gives Delaware. Even where state courts are arguably primary—in internal affairs—"the federal securities regulatory regime is a force in influencing the internal affairs of corporations."<sup>45</sup> And "the New York Stock Exchange ... impose[s] ... internal standards ... [like] minimum standards for audit committees."<sup>46</sup>

But the "internal affairs doctrine" is a long tradition, he pleads, albeit one that could be ended by federal preemption.<sup>47</sup> The Enron debacle and the ensuing controversy over corporate governance could end it, already inducing Congressional and SEC proposals to deal with what otherwise might be internal affairs of the corporation.<sup>48</sup> Then he argues why that traditional separation should not be ended. He

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<sup>42</sup> Justice Andrew G.T. Moore II, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779 (1987).

<sup>43</sup> The Wall Street Journal editorial page, always acerbic and particularly influential during the Reagan-era, lambasted Delaware's partial validation of the poison pill. See *Review & Outlook: Et Tu, Delaware?*, WALL ST. J., Nov. 21, 1985, at 30, cols. 1-2. They attacked Delaware, but does not propose a federal solution. It is, after all, the Wall Street Journal.

<sup>44</sup> *Lewis v. Vogelstein*, 699 A.2d 327, 332 (Del. Ch. 1997).

<sup>45</sup> Veasey, *supra* note 19. Veasey's speech was delivered last April, at an American Bar Association function. E. Norman Veasey is the Chief Justice of Delaware.

<sup>46</sup> *Id.* at 3.

<sup>47</sup> "Absent ... Congressional preemption...." Veasey, *supra* note 19, at 2. He though then concedes that healthy chunk of securities law effectively regulates internal affairs. *Id.* at 3.

<sup>48</sup> Veasey, *supra* note 19, at 9. Veasey was clearly worried about federal over-reaction, quoting various corporate players who were so warning. Over-reaction could be detrimental to the corporation; it would also take critical corporate governance elements away from Delaware, vesting them elsewhere. *Id.*, at 10-11. "[W]e do not take for granted our responsibilities or our reputation.

“sells” the virtues of Delaware over Federal preemption and ouster: trustworthy courts with “integrity, expertise, diligence, good faith, independence and professionalism.”<sup>49</sup> Although “the Enron foment has provoked debate about the effectiveness of [state-law] standards governing directors[,] ... [my] thesis is that the Delaware model works well, over all, ... and that one should be cautious in concluding that current events dictate a new ... regime of corporate governance.”<sup>50</sup>

Delaware is obviously a major creator of the current regime, he argues further. A new regime might not have Delaware at its center is the implicit fact here. Where might that new regulatory regime come from: “There are competing bills in Congress addressing corporate responsibility.”<sup>51</sup> And the SEC might swing into action: “[The SEC chair,] Mr. Pitt [says Justice Veasey, quoting the Wall Street Journal,] has been proposing numerous changes to tighten corporate governance, accounting and disclosure standards in recent months, in part to head off ... action by Congress.”<sup>52</sup> One might see a sense of wistfulness here emerging in Delaware: Enron has already moved the arena into jockeying between the SEC and Congress, with Delaware on the sidelines.

Three months later Congress passed Sarbanes-Oxley, which swept aside key areas of corporate governance and corporate law previously governed by state law.

### C. Has Displaced

So we know that Federal authorities could displace Delaware. We know the “internal affairs doctrine” is just an understanding that can be, and has been, breached. And we know that Delaware players comprehend that it can be, and has been, breached. Here I show how Federal law already deeply affects internal affairs that Delaware purports to regulate. I also show several instances where Delaware said “yes” to a practice, and the federal authorities simply turned around and said “no.” And in several instances Delaware changed its rule in response to the federal action. These specific transactions are going private, the all holders rule, regulation of the leveraged buy-out, and dual class recapitalizations.

Several matters would in any abstract notion of the corporation be considered internal affairs, yet they are not just governed by federal authority, but we hardly hear a whimper anymore from internal affairs doctrine purists that this is so. The securities laws themselves effectively control the voting process in large American firms. One would have thought that this is probably the single most important institution of corporate internal affairs. Yet, since 1934 voting is governed primarily by the

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... [W]e try harder, because life would be much less interesting without the corporate activity that engenders all this ... interesting work.” *Id.*, at 33.

<sup>49</sup> Veasey, *supra* note 19, at 5.

<sup>50</sup> *Id.* at 4. Cf. Leo E. Strine, *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUSINESS LAWYER 1371, 1372 (2002): “Hanging in the balance are important issues... Congress may even ... federaliz[e] key elements of corporate law ... .” Judge Strine is a sitting Vice Chancellor in Delaware.

<sup>51</sup> Veasey, *supra* note 19, at 9.

<sup>52</sup> *Id.* at 9.

Exchange Act, the SEC rules, and federal courts' interpretations. Similarly, one might have thought that accounting could be an internal matter—the reports of the corporation to its stockholders—but these are all federally regulated. Indeed they became federally regulated because of the pre-1934 view that the states just were not doing enough to mandate and make accurate the flow of information from the corporation to its own shareholders. The securities acts are not just regulating the “external” trading of stock on Wall Street or the “external” relationship when the corporation sells its stock to the public. They regulate what in the abstract would be seen as internal affairs, if we did not have this tradition since 1934 of viewing proxy voting and deep detailed accounting to shareholders as matters of federal, and not internal, corporate law.

Federal authorities can take over state law-making on fiduciary duties. Insider trading is one where they have, affecting corporate governance when it's the managers who are buying and selling stock with the company's shareholders. At common law, the states basically permitted insider trading, and this was one basis for federalization in 1933 and 1934. Whatever state race was going on, insider trading was brought into the federal domain in theory in 1933 and 1934,<sup>53</sup> and the ambit of regulation expanded in the 1960s with *Texas Gulf Sulphur*.<sup>54</sup> General fraud liability could be the basis for duties that look like state-law fiduciary duties, and courts were making those incursions, some of them quite deep, in the 1960s and 1970s, until the Supreme Court in 1977 blocked further incursions with *Santa Fe v. Green*. And simple disclosure can charge up fiduciary duties in a way that state law cannot, if potential plaintiffs cannot discover the fiduciary wrong under state mechanisms. What the SEC decides needs to be disclosed—defining the materiality standard, finding causation between trading loss and non-disclosure, listing the transactions, and controlling the accountants' interaction and duties—all can, and do, determine which interested party transaction are effectively regulated, and which are the quibbles that the law ignores.<sup>55</sup> And lastly, by defining issues of professional responsibility—when the company's lawyers must go to the board, blow the whistle; how public an accountant's resignation must be, whether the accountants' ancillary business with the audited firm must be disclosed—the SEC is effectively allocating authority inside the firm. To disclose is to control. To put duties on the gate-keepers is to regulate the internal affairs of the corporation.

And there are also specialized institutions that take away pieces of corporate affairs. The Department of Labor governs pension funds. The DOL has issued well-known directives to pension funds—which own one-quarter of American stock—on how they exercise their vote in corporate elections. Mutual funds—which own one-fifth of American stock—are subject to Investment Company Act restrictions on how they vote. State law might not make their votes public, for example, but federal mutual fund law may do so quite shortly. When leveraged buy-outs were a critical feature of the corporate landscape, some authorities thought that state controls were

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<sup>53</sup> Exchange Act, § 16(b).

<sup>54</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (1968) (en banc), cert. denied 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

<sup>55</sup> See Regulation S-K § 404, which mandates disclosure of wide class of interested party transactions in the company's annual report and any prospectus used to sell securities to the public.



lax; federal controls through the Federal Reserve margin regulations then kicked into place. When executive compensation became a hot issue, congress, before the states acted at all (i.e., before the race could be run) mandated tax rules on excess compensation.

Sometimes federal authorities drop the pretense of regulating around the edges. Sarbanes-Oxley is one such instance. Congress mandates requirements for boards of directors, for relationships with accountants, for what boards must do, and so on. Little could be more internal than what Sarbanes-Oxley reaches. The same for the related New York Stock Exchange rules mandating the objective character of the directors' independence, the composition board committees, and so on.

And Delaware's origins in the first race involved federalization of the key corporate issue of the day. In the mind-set of that time, antitrust law and corporate law were closely intertwined. The state-to-state incorporation movement of the time was first from the state in which business was done, then into New Jersey, then into Delaware. While analyses talk about flexibility and the like as the basis for the race, the fundamental issue was of monopolization and cartelization. The largest firms sought corporate organizational mechanisms that would facilitate monopolization and cartelization. When the original incorporating states did not permit the facilitating means, the firms used trusts as the means of organization. When the trusts failed, New Jersey provided an organizational alternative. And then when New Jersey took it away, Delaware stepped in. These maneuvers induced a call to federalize all corporate law, so that national authorities could control the organizations that made monopolies and cartelized industries. In the end the apple was cut this way: the federal government took over what "mattered" to them, the antitrust issues of monopolization and cartelization. The states were then relegated to the relatively less important (at that time) control of non-monopolizing organization.

And today there are takeovers, perhaps the states major remaining area of full authority. But it almost did not turn out that way. Delaware almost lost authority over takeovers on three Federal fronts in the 1980s: the courts were defining takeover tactics as preempted by the Williams Act and interpreting state takeover statutes as preempted by that Act and the United States Constitution; the SEC was using open-ended authority from the Williams Act to micro-regulate takeover tactics; and Congress was seriously considering a takeover statute that would preempt Delaware. By the end of the 1980s, each Federal foray reversed itself, and the Federal authorities left takeovers to the states. But we begin here, as the partial ouster of the 1980s—which could just as easily been placed in the "inspires fear" section just above, as Delaware reacted to federal threats to displace further—because the Delaware sequence cannot be well-explained here by either race theory. But, with the federal threat in mind, we can not only explain much of the Delaware move, but we can help to explain emerging data on takeovers better than either of the race theories explain the data.

*1. Takeovers in the early 1980s.* Consider Delaware takeover law. Most commentators viewed Delaware takeover law as among the most pro-shareholder and least managerial in the 1980s. Its decisions were "proportional;" its antitakeover legislation non-existent until the late 1980s, and mild then. At the same time other

states were producing one antitakeover law after another, watching them get knocked down at the Federal level, as preempted by the Williams Act or the interstate commerce clause. Delaware though passed no anti-takeover laws until 1987, and then a mild one. But by the end of the decade, with the 1989 *Paramount* decision, Delaware turned antitakeover, and hasn't gone back.

If Delaware was racing to the top in providing pro-shareholder takeover law in the 1980s, why did it stop racing by 1990 or thereabouts? And if Delaware usually races to the bottom, pandering to managers, why did it take so long for it to get there? The issues in takeovers were not subtle, and the interstate pressures on Delaware were powerful: The other states were passing powerful antitakeover laws. (The only issue was whether Federal authorities would let these laws stick.) Managers were pressing Delaware to go fully antitakeover. Their lawyers, evidenced by Martin Lipton's famous public call for reincorporation out of Delaware, wanted antitakeover law. The demands of the race were as plain as could be for Delaware. Lipton said:

The *Interco* case and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.<sup>56</sup>

Yet Delaware's mid-1980s decisions zig-zagged through takeover doctrine: *Revlon* putting strong duties to sell on directors; *Unocal* looking for proportionality; even *Moran* said directors would have duties to "yank the pill," and could not—to use the later vocabulary—"just say no." *Interco* did so explicitly: target managers could not use the poison pill to "just say no," but only to find another bidder or to defeat a coercive tender offer, such as a two-tiered offer. (The two-tiered offer gives more money to those who rush to tender, less to those who hold back, creating an incentive for shareholders, even those disliking the overall terms, to give up for fear of being on the low-value "back-end.".) But if the outsider made its offer to any and all shares, said the *Interco* court, then the implication of *Moran* was that the target had to dismantle its defensive machinery and could not use new defensive maneuvers.<sup>57</sup>

And the Delaware legislature was quiet, not passing any early anti-takeover statute and then, when it did, passing one that was relatively mild. It was not that the legislature did not then know how to respond to managers: when the duty of care was called into question, the legislature promptly facilitated freeing managers from liability.<sup>58</sup> They were just quiet on takeovers, not quiet overall.

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<sup>56</sup> Martin Lipton, To Our Client: The *Interco* Case, Nov. 3, 1988 ("private" mailing). The idea did not stay hidden. See Tim Smart, *For Managers, Delaware Isn't the Haven it Used to Be*, BUS. WK., Dec. 19, 1988, at 33 ("legal advisers to worried managers already are suggesting that companies ... consider playing elsewhere ...."); Charles Storch, *As company, Time focusing on 1 newsmaker*, CHICAGO TRIBUNE, July 9, 1989, at 8 (Delaware's blocking *Interco* management from using the pill "so enraged Martin Lipton, the lawyer ... credited with inventing the ... pill ..., that he urged his ... clients to consider reincorporating elsewhere."); Stephen Labaton, *The 'Poison Pill' Takes a Beating*, N.Y. TIMES, Nov. 14, 1988, at D2; Roger Parloff, *The Outlook of Poison Pills: After Interco and Pillsbury, What Next?*, MANHATTAN LAWYER, Jan. 24-30, 1989, at 31

<sup>57</sup> *City Capital Associates v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988).

<sup>58</sup> See Del. Gen'l Corp. L. § 102(b)(7), enacted in 1986.

Then, around 1989 or 1990, the Delaware courts turned to the antitakeover fork in the path. By including the federal dimension we explain Delaware better than any pure race-to-the-top or race-to-the-bottom theory can. Delaware's internal political structure *could* allow for pro-shareholder takeover law because its local political configuration differed from, say, the Rust Belt states that the strongest bastions of antitakeover law in the 1980s. Delaware just did not have the antitakeover lobby the Rust Belt states had. Still, if Delaware wants the incorporation business, it presumably would match the other states bidding in a race. State-to-state competition should have induced it to "match" the other states. But it did not in the 1980s.<sup>59</sup>

But in the 1980s Delaware had reason to fear ouster from the federal authorities more than it had reason to fear the anti-takeover law of the Rust Belt states. The Federal authorities were producing pro-takeover law via the SEC and the courts, and threatening to enact preemptive moderate takeover law via Congress. If Delaware misstepped, if it was too far out of line with the Federal actors, it could tip one or another of those actors, especially Congress, into stronger, hard-to-reverse action that would oust Delaware of what would become its most important hold on corporate affairs, the takeover.

(a.) *The executive branch: White House politicians; SEC commissioners*—The 1980s Washington atmosphere was pro-takeover, before the insider trading scandals hit later in the decade. Reagan-era officials promoted views of takeover entrepreneurs like Carl Icahn as populist heroes attacking corporate bureaucracies that had become elitist sinecures for the rich and ineffective.<sup>60</sup> There was nothing subtle about the Reagan Administration's pro-takeover actions: The White House Council of Economic Advisors opposed the end-of-the-decade Delaware statute when it was proposed, one Commissioner bluntly threatened Delaware with preemption if it acted,<sup>61</sup> another said the Delaware legislation would be constitutionally impermissible,<sup>62</sup> and the SEC Chair said federal preemption was the proper policy:

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<sup>59</sup> Delaware has other considerations. The 1980s takeovers were initiated by outside "raiders," like T. Boone Pickens and Carl Icahn, or by large firms seeking to take-over smaller ones. The latter is a Delaware constituency, the former not. Since many large offering firms are Delaware-chartered, Delaware has reason to heed their goals. But over time, the "raider"-induced takeovers declined, leaving only the large firm initiated takeovers. That would have meant that Delaware would over time have had more pressure to be a moderate on antitakeover laws—targets still resisted as before, but the portion of the offerors that were Delaware's corporate constituency increased. Yet during this period, Delaware became more antitakeover when the non-Delaware "raiders" were disappearing, not less antitakeover. The release-of-Federal-pressure story that I develop in the text fits Delaware's movement.

<sup>60</sup> Peter T. Kilborn, *Treasury Official Assails "Inefficient" Big Business*, NEW YORK TIMES, November 8, 1986, at A1. The speech came from Richard Darman, a key Reagan-era player.

<sup>61</sup> See Letter of Joseph Grundfest, Commissioner of the Securities and Exchange Commission, to David Brown, Council of the Corporation Law Section of the Delaware State Bar Association, dated Dec. 10, 1987, reprinted in CRAIG B. SMITH & CLARK W. FURLOW, GUIDE TO THE TAKEOVER LAW OF DELAWARE, app. E, at 161, 165 ("a decision by Delaware to adopt an antitakeover statute ... is more likely to provoke a federal response ..."). And: "For present purposes it is sufficient to observe that enactment of Section 203 [would] increase[] the probability of federal scrutiny." *Id.*, at 165.

<sup>62</sup> See Letter of Charles Cox, Commissioner of the SEC, to the Council of the Corporation Section of the Delaware Bar Association, date Dec. 10, 1987, reprinted in SMITH & FURLOW, *supra* note 61, app. D, at 157.

"Federal law should control [takeovers] by preempting state statutes that unduly interfere with the free transferability of securities."<sup>63</sup> In case Delaware did not get the message, the SEC Chair two months later wrote a leading Delaware corporate lawyer (one deeply involved in drafting the Delaware law), quoting the preemption speech to him, the lawyer who would in due course become Chief Justice of the Delaware Supreme Court.<sup>64</sup> Delaware acted, but, compared to every other state, it acted moderately.

(b.) *The courts and constitutional preemption; the Williams Act and the SEC*—And courts through most of the 1980s were knocking down most (but in the end not all) state anti-takeover statutes as conflicting with the dormant commerce clause:

The Illinois Act is ... unconstitutional ... for even when a state statute regulates interstate commerce indirectly, the burden imposed ... must not be excessive in relation to the local interests served ... The most obvious burden the Illinois Act imposes on interstate commerce arises from the statute's ... nationwide reach ... giv[ing] Illinois the power to determine whether a tender offer may proceed anywhere. ... Shareholders are deprived of the opportunity to sell their shares.... The reallocation of economic resources to their highest valued use ... is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.<sup>65</sup>

At the same time, the courts were defining the on-the-ground takeover tactics as covered by the William Act's provisions banning manipulative or deceptive practices in tender offers. In *Mobil v. Marathon*, the Sixth Circuit ruled that Marathon Oil's giving of a crown jewel option to U.S. Steel to ward off another party's takeover offer was a manipulative act, one that the Williams Act barred. Mobil Oil had sought to buy Marathon, whose managers did not want to be employees (or, more likely, ex-employees) of Mobil if Mobil succeeded. They gave U.S. Steel an option to buy 17 percent of Marathon's stock (a "lock-up") and an option to buy part of Marathon's huge, rich Yates oil field (a "crown jewel" option). If Mobil succeeded it would find key assets leaving (at below market prices) and be obligated to sell stock to U.S. Steel at a price favorable to the buyer.<sup>66</sup> If the decision persisted, all takeover tactics would be regulated nationally, not by the states.

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<sup>63</sup> Address by SEC Chairman David S. Ruder, 26<sup>th</sup> Annual Corporate Counsel Institute, Chicago, Ill. (Oct. 7, 1987), quoted in Letter from SEC Chairman David S. Ruder to E. Norman Veasey, Esq., dated Dec. 8, 1987, reprinted in SMITH & FURLOW, *supra* note 61, app. C, at 155. Veasey would thereafter become chief justice of the Delaware Supreme Court.

<sup>64</sup> *Id.* (letter from SEC Chairman Ruder to Norman Veasey). The letter from Chairman Ruder is remarkably simple. It's only one blunt page, stating "I believe that Federal law should control [takeovers] by preempting state statutes .... I believe that corporations whose activities and ownership are national in scope should not be given protection against takeovers by the states [even those] where their primary production facilities are located." These matters, he said, by the way, were not internal affairs of the corporation, but national affairs: notice how the line for internal affairs gets drawn based on what one wants to, or does not want to, regulate.

<sup>65</sup> *Edgar v. MITE*, 457 U.S. 624, 643 (1982).

<sup>66</sup> *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6<sup>th</sup> Cir. 1981), cert. denied, 455 U.S. 982 (1982).

When Delaware allowed targets to self-ender without including the larger, offering shareholder in the tender, the SEC promptly reacted with its all-holders rule, simply turning that switch off.

(c.) *And Congress of course*—Congress was a big threat to Delaware. Congressional committees held hearings, considered legislation, and at some points was thought likely to take control of the takeover issue. And what was the contemplated Congressional action like? If it was pro-takeover, or middle-of-the-road, then Delaware had reason to fear that a sharp anti-takeover act on their part would provoke Congress into a) action, and b) federal preemption. Did Delaware have reason to believe that its main competitor in the 1980s in making takeover law was the federal government, especially the congress?

Consider the simple fact that the principal bill considered in the late 1980s would have preempted Delaware. Little else could make Delaware sensitive here. Antitakeover activists in management aggressively opposed the preemption provisions of the proposed bills. Bruce Atwater, an articulate spokesman for the managers, so testified. The Business Roundtable and the National Association of Manufactures also opposed federal preemption. Shareholder activists did not.<sup>67</sup>

And the bills' substance was middle-of-the-road, not anti-takeover. Although they regulated bidders tactics, extending and deepening the Williams Act style notice-rules on offerors, the bills would have *also* come down hard on defensive tactics, including the poison pill. The principal bill, the one introduced by Representative Dingell and Markey, the big players in the House, in its section entitled "Abusive Defensive Tactics: Poison Pills; Lock-up; Tin Parachutes, would have authorized the SEC to issue rules making it "unlawful for any issuer to establish or implement, during any proxy contest or tender offer ... *any defensive tactic in violation of such [SEC] rules.*" And so that the SEC would not mistake the anti-pill message, the act said that "at a minimum, [its rules must] *treat as a defensive tactic requiring shareholder approval*" of any poison pill measure.<sup>68</sup>

Most importantly for the thesis here—that if it's big, Congress might step in—is that Delaware had reason to fear full federal preemption. Consider just the title of an article from one widely-read business periodical: "States vs. Raiders: Will

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<sup>67</sup> See *Witnesses at Takeover Bill Hearing Split on Preemption of State Regulation*, 19 SEC. REG. & L. REP. (BNA) 851 (June 12, 1987). Professor Roberta Romano argues in a well-known passage in her well-known book, that congressional law-making would have been as anti-takeover as the state legislation. This it might have been—we'll never know for sure. But, first, well-known anti-takeover activists from the Business Roundtable, like Bruce Atwater lobbied *against* federal preemption: if the federal bill would overall have been as, or more, pro-manager as state law, what worried them about a federal act? Second, the leading bill contained *anti*-poison pill measures that management detested, measures that are the core of managerial defensive tactics that the states validated. Although Romano states that poison pills were not a part of the federal takeover bills, ROMANO, *supra* note 4, at 80, she presumably is referring to bills from the early 1980s, not the Dingell-Markey 1987 bill, which would have ended the pill. Her conclusion though is understandable given her focus. She collated the takeover provisions of bills introduced from 1969 to 1987, and used that as a measure. *Id.* at 79. But the poison pill did not become a serious tactic, or even an issue, until about end of that period. And it would have been banned by the most serious bill, that of Representatives Dingell and Markey, the chairs of the relevant committee and sub-committee.

<sup>68</sup> *Tender Offer Reform Act of 1987*, H.R. Bill 2172, Apr. 27, 1987, 100<sup>th</sup> Cong., 1st Sess. § 14.

Washington Step In?”<sup>69</sup> Consider next the second federal fact and how it tracks Delaware development: by the early 1990s, the Federal authorities, once pro-takeover, disappeared from actively making, or even thinking about making, takeover law.

(d.) *The Federal abdication*—It came first in the Courts, with the Supreme Court cutting back first on the Williams Act’s preemptive power: manipulative practices were interpreted to include bid-rigging, not defensive maneuvers and strong-arm bidding tactics.<sup>70</sup> But *Edgar v. MITE*’s preemptive power—the states could not burden interstate commerce, even if the Williams Act did not allow federal authorities to regulate takeover tactics—still stood, until *CTS* ended it in 1987, when the Supreme Court reversed circuit court preemption of state antitakeover action.

The SEC though was still visibly pro-takeover in 1987, and it influenced congressional policy-making. But in the following few years its once aggressive stance faded away. Personnel changes best explain the result—a drafter of state anti-takeover legislation went onto the commission in the early 1990s, at the same time as its most vociferous pro-takeover commissioners left it.<sup>71</sup> Congress too finally faded from the field by the end of the 1980s, and stayed untempted to return in the takeover drought of 1990 to 1992 and the strong economy of the later 1990s.

(e.) *The Federal gravitational pull on Delaware?*—Delaware’s moves roughly can be explained by the federal moves. When the federal government was overall pro-takeover, Delaware was reticent or middle-of-the-road, proclaiming proportionality, and zig-zagging from *Moran* (itself with limits) to *Revlon* (tough, anti-manager, pro-takeover), resisting passing an anti-takeover statute longer than the other states, and passing a mild one when it acted. Then with *Paramount* in 1989 Delaware became anti-takeover. Zig-zagging stopped for the most part (or the anti-takeover zigs were sharper than the moderate zags).

We can trace the cases briefly, although this story is well-known. *Unocal* announced proportionality in 1985;<sup>72</sup> ten years later, in 1995, the Delaware Chancery Court, arguably following the *Unocal* standard ten years later was then reversed by the Delaware Supreme Court in *Unitrin*.<sup>73</sup> *Unocal*, decided in 1985, was not a pure pro-takeover decision. At the time the other states were producing very strong antitakeover law (via legislation and statute), but this decision is usually viewed as intermediate: responses by managers had to be proportional to the outside threat to the corporation or its shareholders. Reaction had to be proportional; “just say no” was

<sup>69</sup> Vicky Cahan, *States vs. Raiders: Will Washington Step In?* BUSINESS WK., Aug. 31, 1987, at 56. The bill would also have required one-share, one-vote and a mandatory bid rule.

<sup>70</sup> *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985).

<sup>71</sup> Compare pronouncements from Joseph Grundfest, an aggressively pro-takeover Reagan appointee, see Grundfest Letter, *supra* note 61, and Joseph Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (2000), with actions by Stephen Waldman, a later appointee who drafted Pennsylvania’s tough antitakeover laws.

<sup>72</sup> As did *AC Acquisition Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. 1986). See Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is there Substance to Proportionality Review*, 44 BUSINESS LAWYER 247 (1989).

<sup>73</sup> Compare *Unocal Corp. v. Mesa Petroleum Co.*, 193 A.2d 946 (Del. 1985) with *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995). The 1994 *QVC* decision does not fit this line, but was arguably pushed back by *Unitrin* in 1995. *Paramount Communications Inc. v. QVC Network Inc.* 637 A.2d 34 (Del. 1994) (applying *Revlon* duties).

unlawful. If the race is to that bottom, one wonders why Delaware not only did not run there, but also for most of the 1980s did not hit an antitakeover bottom. The federal threat story I offer here plausibly explains Delaware.<sup>74</sup> Delaware went for the middle ground. And still the SEC overturned the specifics of *Unocal*, barring a selective self-tender (although not touching the proportionality standard of the decision).<sup>75</sup>

In *Revlon*, the Delaware courts were tough on targets: once the firm was to be sold, the board could not pick and choose but had a fiduciary duty to conduct a sale that would yield the shareholders the highest dollar, presumably through an auction.<sup>76</sup> This duty was considered so important that lawyers referred to it as the “Revlon duty,” often quipping about how a target company was entering “Revlonland.” *Moran* validated the pill in 1985, but said that managers could use the pill to ward off coercive offers, not to “just say no.”

But by the end of the decade the takeover machine hits *Paramount* and “Revlonland” became a very, very small place. There was in *Paramount* what everyone would call a sale of Time, via a merger between Warner and Time. Paramount was offering more for Time, and the players might have thought that Time had entered “Revlonland,” with a *Revlon* duty to sell to the highest bidder. But the Delaware Supreme Court said the board could pursue “a deliberately conceived corporate plan ... unless there is clearly no basis to sustain the corporate strategy.... The board dismissed *Revlon*’s relevance (the company was being sold not broken up), and Time’s shareholders lost Paramount’s \$200 per share bid, with Time management forcing Warner’s lower \$138 per share on them.”<sup>77</sup>

How did 1985 and 1989 differ?: I submit that what happened was that the Federal government withdrew from the takeovers. With the federal pressure off, Delaware could act more freely. Its main competitor in making takeover law had given up. It could then act more freely, either implementing its own conception of the proper role of management in takeovers, or buckling under managerial pressure, or concluding that there was no percentage in have its own takeover rules differ substantially from those of sister states (which were overwhelmingly anti-takeover) if the Federal pressure had abated.

One could argue that the federal authorities exerted a gravitational pull up during the 1980s, and, when they released Delaware at the end of the 1980s, Delaware dropped to the bottom. Or, one might argue that the federal government’s gravitational pull continued, but shifted. By the early 1990s Washington takeover politics was

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<sup>74</sup> One might say that “proportionality” was not just the duty of the board (to fashion a response proportional to the threat) but was also where Delaware was: proportional, or in the middle between Washington and the Rust Belt states.

<sup>75</sup> Exchange Act Rule 14d-10, 17 C.F.R. § 240.14d-10.

<sup>76</sup> *Revlon v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1985).

<sup>77</sup> *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989). And:

Delaware law confers the management of the ... enterprise [on] the ... board ... [, which] select[s] ... a time frame for achiev[ing] ... corporate goals. That [task] may not be delegated to the stockholders. Directors are not obligated to abandon ... corporate plan[s] for a short-term shareholder profit ... .

*Id.* at 1154. This passage is still read in Delaware as rejecting Interco’s limits to the board’s discretion in resisting a takeover. See *In re Pure Resources, Inc.*, 2002 WL 31300797 n.38 (Del. Ch. Oct. 7, 2002).

changing. Scandals in inside-trading and at Drexel Burnham were de-legitimizing takeovers. The stronger economy by the mid-1990s seemed not to need takeovers to perform well, so public-spirited policy-makers had less reason to focus on takeovers as an engine of economic renewal. Political changes in Washington removed the most pro-takeover players from the White House and the SEC. In this second view, Delaware moved in tandem with the Federal mover, maybe a little faster and a little farther, but still roughly in tandem.

The Federal gravitational force also fits the direction of change in newly-emerging data, albeit roughly and with a lag: New data associates Delaware incorporation with higher firm value than incorporation in other states in the 1980s and early 1990s, and the most plausible explanation is Delaware's mildness on takeovers.<sup>78</sup> This premium disappears by 1995 in the initial follow-on study.<sup>79</sup> The data fits racing badly (if to the top, why did it take so long? If to the bottom, ditto?). It fits the Federal gravitational pull better.<sup>80</sup> Some time after Delaware had made its point—and some time after it was free from takeover federalization—the data moved, with Delaware's premium over other states for shareholders disappearing.

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So, whether or not one adopts a release theory or a movement-in-tandem theory, the result here—the fear of federalization thesis and a federal gravitational pull—is central to understanding the making of American takeover law. When its main competitor was competing, Delaware toed a line closer to Washington than to the other states.<sup>81</sup>

2. *Four specific sharp federal incursions.* We have four specific modern instances of Federal law directly displacing state corporate law: going private transactions, the all-holders rule, the leveraged buy-out, executive compensation, and dual-class recapitalizations.

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<sup>78</sup> Daines, *supra* note 1.

<sup>79</sup> Guhan Subramanian, *The Disappearing Delaware Effect* (Harvard Law School working paper, 2002). Subramanian confirms the Daines' Delaware premium for the period before 1996. Another study finds no Delaware premium in 1999: Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate* (Harvard Law & Economics Paper No. 341, 2002). And, another study shows data consistent with Delaware incorporation as beneficial at the beginning of the 1990s but detrimental by the decade's end. [Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices* (NBER Working paper no. 8440 (Aug. 2001).]

<sup>80</sup> The misfit is the lag: the Delaware effect disappears, but not right after Delaware turned anti-takeover. Subramanian's explanation is that it took a while for *Paramount* to sink in. Another possibility is that it first sank in via the decline in hostile takeover activity in the early 1990s right after *Paramount* (and the demise of Drexel during a soft economy), and then sank in deeper via value later, when it was clear that the Federal pressure on Delaware was not returning. In any case, racing theory cannot explain the change in the data's direction; the Federal gravitational pull does better.

<sup>81</sup> One might counter the now-standard view that American takeover law no longer facilitates hostile takeovers with the rise in takeover frequency in the second half of the 1990s. The prevailing academic view (a view that I share) is that higher CEO compensation—vesting those huge options—facilitated takeovers in the face of antitakeover corporate law. The managers win, but in a Coasean maneuver, they take their winnings in cash instead of tenure. Marcel Kahan & Edward Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002). A stronger board probably also played a role.



(a) *Going private and the SEC*—In the 1960s and 1970s a common corporate transaction was to “go private.” A firm had a controller, with a smattering of public stock. The controller decided to take the firm private, eliminating the public stockholders. Often there were good business reasons: more confidentiality, lower expense, etc. But whether there were good reasons or not, the price paid and the process used were controversial corporate issues at the time. The SEC wrestled with Delaware on this one. The Delaware cases at first validated going private, holding generally that the dissenting shareholders’ only remedy was to get appraisal rights,<sup>82</sup> a remedy that many viewed as inadequate.

The SEC disgust with these Delaware case was hardly hidden. SEC Commissioner A.A. Sommer, after reciting the terms of a going private transaction in which the firm went public and then private in which the dominant shareholder would gain 400% “without a single dime of additional investment [from] her!” The Commissioner concluded: I would suggest there is something wrong with that.”<sup>83</sup> Moreover, the problem is generic: “[f]or some time now there has been widespread criticism of the inadequacies of state corporation law.”<sup>84</sup> And, he added, “[t]here are many reasons for [the recent] expansion of federal law. First has been the recognized insufficiency of state laws.”<sup>85</sup> Why insufficient? Because “Delaware [is] notorious for the favor its laws show to management, often at the expense of shareholders.”<sup>86</sup>

Eventually the SEC promulgated Rule 13e-3: “Going Private Transactions By Certain Issuers ...,” which expressed more scorn for state law than did Commissioner Sommers, albeit more politely: “[A]pplicable state law ha[s] not always provided an adequate remedy to the potentially deleterious effects of going private transactions.”<sup>87</sup> Delaware shortly afterwards reversed itself.<sup>88</sup> Via the late 1970s Delaware decisions, says a critical analyst, “the Delaware Supreme Court ... strengthened considerably the power of minority shareholders vis-à-vis management [in going private transaction].”<sup>89</sup>

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<sup>82</sup> *Stauffer v. Standard Brands, Inc.*, 187 A.2d 78 (Del. 1962); *David J. Greene & Co. v. Schenley Indus.*, 281 A.12d 30 (Del. Ch. 1971); *Singer v. Magnavox*, 367 A.2d 1349 (Del. Ch. 1976).

<sup>83</sup> See Address by A.A. Sommer, Jr., SEC Commissioner, [1974-75 transfer binder] CCH Fed. Sec. L. Rep. ¶80,010. Cf. *Kahn v. United States Sugar Corp.*, 1985 WL 4440 (Del. Ch. 1985).

<sup>84</sup> A.A. Sommer, Jr., *Further Thoughts on “Going Private”*, *Full Text of Commissioner Sommer’s Speech on “Going Private”*, SEC. REG. L. REP. (BNA), Mar. 19, 1975, at D-3.

<sup>85</sup> *Id.* at D-2.

<sup>86</sup> A.A. Sommer, Jr., “*Going Private*”: *A Lesson in Corporate Responsibility*, *Full Text of Commissioner Sommer’s Remarks on “Going Private”*, SEC. REG. L. REP. (BNA), Nov. 20, 1974, at D-1.

<sup>87</sup> Securities Act Release No. 5884, *Going Private Transaction By Certain Issuers and their Affiliates*, Nov. 17, 1977, 42 Fed. Reg. 60,090, 60,091-92 (1977) (proposing SEC Rule 13-e).

<sup>88</sup> On the perceived link between the SEC rule and Delaware reversal, see Fischel, *supra* note 4, at 915.

<sup>89</sup> *Id.* at 914. Fischel juxtaposes the Cary initiative and Congressional hearings next to Delaware’s strengthening. The SEC’s proposed rule sought substantive fairness, deriving its authority to do so from the SEC’s authority to deal with “fraudulent, deceptive or manipulative act[s].” The SEC pulled back from substantive fairness, although it did so after Delaware moved to require substantive fairness. See generally Christopher R. Gannon, *An Evaluation of the SEC’s New Going Private Rule*, 7 J. CORP. L. 55, 64 (1981).

Whether Delaware reacted to the SEC chastisement, whether they were embarrassed by the SEC's forced disclosure of pricing information (making the Delaware remedies appear inadequate), or whether they were positioning themselves with the then-growing, sympathetic response to William Cary's Federal minimal standards proposal in mind is just too hard to ever know. But the reaction fits awareness, pressure, and reaction. Indeed the courts reversed themselves mid-stream on going private. The Delaware *Singer v. Magnavox* sequence was: first, lower court anti-shareholder decisions, punctuated by SEC criticism and action, and finally Delaware Supreme Court reversal: The Delaware Supreme Court overturned the lower court's exclusive remedy decision in *Singer v. Magnavox*, allowing disgruntled shareholders more remedies than just the weak appraisal remedy and requiring that the defendants satisfy a test of "entire fairness."<sup>90</sup> The leading text on mergers and acquisition law speculates that the Delaware Supreme Court's decision is best explained as one intended to deter turning the talk of more federalization into actual federalization.<sup>91</sup> And shortly thereafter the Supreme Court went further, overturning the specifics of the restrictive mechanics of the earlier exclusive remedy decisions as well.<sup>92</sup>

If Delaware were reacting to federal pressure to be tougher on controllers, then one would expect the controllers to complain. And they did. Anecdotal evidence is that in the early 1980s, Delaware was looked upon suspiciously as a state of incorporation: "corporate lawyers [were] recommend[ing] *against* Delaware incorporation ... [because] Delaware's judiciary was too 'moralistic.'"<sup>93</sup> (It's possible to speculate that Delaware's final moralizing reaction to Cary and the 1970s federalization debate came in 1985 with *Van Gorkom*—the toughest, most anti-managerial decision to come out of the Delaware courts. That decision put Delaware at risk of losing reincorporation business until it retreated, as the legislature did a year later with § 102(b)(7), effectively over-turning the judges' work in *Van Gorkom*.)

This though—Delaware's early 1980s moralizing—is inconsistent with a pure race-to-the-bottom theory, which portrays Delaware as pandering to those who initiate

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<sup>90</sup> *Singer v. Magnavox*, 380 A.2d 969, 980 (Del. 1977). Delaware went through a similar reversal on the adequacy of a dominant stockholder's disclosure of pricing information in a merger. Compare *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976), rev'd 429 A.2d 497 (Del. 1981) with *Lank v. Steiner*, 224 A.2d 242 (Del. Ch. (1966) and *Poole v. N.V. Deli Maatschappij*, 224 A.2d 260 (Del. Ch. 1966). The defendant in *Vickers* would have had to disclose the base-line information under the federal proxy rules, as the Delaware court recognized, 351 A.2d at 572, and one might see this sequence as Delaware finally getting into line with modern federal proxy standards. And one might argue that Delaware caught up with 75 years of federal disclosure requirements in *Malone v. Brincat*, 772 A.2d 5 (Del. 1998), in which the Delaware Supreme Court said that "[w]henver directors communicate publicly or directly with shareholders about the corporation's affairs ... have a fiduciary duty to exercise care, good faith and loyalty." Previously Delaware had only found such a duty if the directors sought shareholder action, approval, by a vote.

<sup>91</sup> RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1256 & n.40 (2d ed. 1995).

<sup>92</sup> *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979).

<sup>93</sup> John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 768 (1987) (emphasis supplied).

the reincorporation decision: managers and controllers. It is, however, consistent with a theory that depends on federal pressure as critical to Delaware's calculus.

Perhaps the judges did not understand that they were supposed to be racing. The report of anti-Delaware reincorporation pressure, anecdotal to be sure, is, moreover, inconsistent with either race theory: If "toughness" is racing to the top, Delaware should have garnered charters from those looking for toughness. If "toughness" is racing to the bottom, then Delaware should have garnered charters this way. To take on a policy that loses charters is to give up on the race.

Only when we see Delaware as reacting to avoid further federal incursion into corporate law-making, does the Delaware result here become explicable. A policy of toughness is consistent with the view that Delaware corporate players had an eye on Federal authorities, and felt confined (psychologically or otherwise) by the Federal authorities *not* by the competing states.

(b). *The all-holders rule and the SEC*—In *Unocal*, the Delaware Supreme Court allowed a takeover target to exclude a bidder from the company's self-tender for its stock. The discriminatory bid would deter the outsider from taking over the company.

True, the rhetoric of the decision was moderate—managers could only use tactics proportional to the threat the firm and its stockholders. The two-tiered bid from Pickens hurt some shareholders: shareholders who did not sell to Pickens initially would be paid less than those who sold rightaway. The tactic was unfair to some, and potentially manipulative of shareholders. And Pickens had taken "green-mail" before. (That is, he desisted from other takeovers when the company bought back his stock, usually at a nice premium.) The company's exclusion of Pickens was proportional to the threat, concluded the Delaware Supreme Court. One might consider this an internal affair of the corporation, i.e., the matter was one of the firm's relationship with its shareholders, a matter akin to a selective dividend going to some but not all shareholders. Such a matter would usually be regulated by the states.

Internal or not, the SEC reaction was simple and swift. With the all-holders rule, Rule 14d-10,<sup>94</sup> the SEC demolished the specifics of state law on a selective buy-back.<sup>95</sup> Nothing uncertain about: The SEC said their purpose was to reverse the Delaware tactical result.<sup>96</sup>

(c). *Dual-class recapitalizations and the stock exchanges*. In the 1980s many firms recapitalized with dual class stock, by which insiders got stock rich with votes; and outsiders voting (perhaps under a collective action debility) to give up their vote. Delaware had no problem with dual class recapitalizations.<sup>97</sup> Yet commentators in the

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<sup>94</sup> Rule 13e-4, 17 C.F.R. § 240.13e-4; Rule 14d-10, 17 C.F.R. § 240.14d-10. The first regulates self-tenders (the *Unocal* actual transaction), requiring that offers be made to all stockholders; the second regulates outside offers.

<sup>95</sup> And, less well-known, Congress sought to tax greenmail, a similar transaction, out of existence. IRC § 5881. Federalization proceeded on two fronts: the tax code and the SEC rules.

<sup>96</sup> *Proposed Amendments to SEC Tender Offer Rules*, 17 Sec. Reg. L. Rep. (BNA) 1320, 1321 n.5 (1985).

<sup>97</sup> *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977) (original charter can allow differential voting rights); *Williams v. Geier*, 671 A.2d 1368 (Del. 1996) (*Providence* permissiveness not limited to original charter; midstream recapitalizations can change voting allocation). Other states had no trouble with dual-class recapitalizations. *Groves v. Rosemound*

main thought mid-stream recapitalizations leaving outside stockholders voteless were deleterious.<sup>98</sup> Again, one might have thought the question of voting and of the firm asking shareholders to give up their vote (for, say, a slightly higher dividend) would be a corporate internal affair. But the SEC promulgated Rule 19c-5, which had it survived would have barred all exchange-listed stock from dual class recapitalization. But then the internal affairs doctrine showed itself to have some bite, although it ultimately lost. The DC Circuit invalidated Rule 19c-4: 19(c) of the 1934 Act did not allow the SEC to promulgate substantive corporate governance in derogation of state corporate law. These internal affairs are for the states not the SEC.<sup>99</sup>

This seems to have been, and was, a defeated effort at federalization, one that would free Delaware from fear of federalization, at vis-à-vis dual class recapitalizations. One might have thought that without an act of Congress, Delaware was free. But the SEC has more means to act. By 1994, the stock exchanges, under pressure from the SEC, all put through anti-dual-class rules. Effectively Delaware was preempted again, this time by the exchanges under SEC pressure.<sup>100</sup>

(d). *Pensions, proxies, and the Department of Labor.* Federalization is not just regulation of the company; it is regulation of its stockholders. Some stockholders are directly told how to act in corporate governance. By telling them how to act, federal authorities take key corporate law decisions away from traditional corporate law-makers. Pension funds are told via federal ERISA regulation that they must consider the corporate proxy in the stock they own to be an asset whose use must be actively evaluated. Mutual funds are about to be told they must announce how they vote on proxy initiatives.<sup>101</sup>

These may seem like specialized exceptions, but they cover about half of the shares, and companies, in the American economy. Twenty percent of the stock market is owned by the mutual funds; twenty-five percent is owned by the pension funds.<sup>102</sup> How they—just about half of the American stockholders—act here is governed by Delaware law, but by federal law.<sup>103</sup>

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Improvement Ass'n, Inc. 413 So.2d 925 (La. App. 1982); *Hampton v. Tri-State Fin. Corp.* 495 P.2d 566 (Del. App. 1972); *Shapiro v. Tropicana Lanes, Inc.* 371 S.W.2d 237 (Mo. 1963). *Stroh v. Blackhawk Holding Corp.*, 272 N.E.2d 1 (Ill. 1971).

<sup>98</sup> Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3 (1988); Louis Lowenstein, *Shareholders Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979 (1989). Cf. Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

<sup>99</sup> *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

<sup>100</sup> NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 313(A).

<sup>101</sup> SEC Release 2002-139, *Commission Proposes Disclosure of Proxy Voting by Mutual Funds, Investment Advisors*, dated Sept. 19, 2002.

<sup>102</sup> Federal Reserve Flow of Funds, Second Quarter 2002, Sept. 16, 2002, at L.213.

<sup>103</sup> And there's a class of firms—usually financial institutions—whose internal workings are governed by federal law. The boards and ownership structures of mutual funds, banks, and ERISA-regulated pensions are all matters for federal authorities.

These are four sharp examples. There are others, perhaps less sharp, coming via other federal means. Consider the Internal Revenue Code's efforts on executive compensation and the Federal Reserve's efforts on the leverage in leveraged buyouts.

In the 1980s and 1990s executive compensation became more controversial than it had been. Congress reacted via the tax code. Golden parachutes—by which senior executives were paid handsomely when they unexpectedly left the firm, were taxed to discourage their use.<sup>104</sup> Executive compensation above \$1 million was made non-deductible to the corporation unless the compensation was tied to the company's well-being, i.e., tied to the company's earnings or stock price. And tax rules required shareholder approval for the stock options to be tax deductible.<sup>105</sup> Compensation committees came to be regulated more recently. And, most importantly the SEC regularly mandates precise disclosure of executive compensation.

Executive compensation mechanics could have been seen as an affair internal to the corporation. Some firms might wish to keep compensation private. They might wish that compensation be decided by a board committee whose members can tightly prime compensation to performance (however dangerous that kind of confidential structure might be). The internal workings of the firm might militate that compensation be hidden from, say, suppliers. That's how state law would run here. But federal law trumps state law to the contrary: the compensation *must* be stated to the shareholders, not just the board compensation committee. And the shareholders now approve that compensation (or vote it down), and the composition of that board committee is determined not under state law, but elsewhere.

In the 1970s and 1980s leveraged buyouts became common. A cousin to going private transactions, they begin with a controller, either inside managers or an outside buyout firm with a thin equity investment, using the buy-out company's assets to borrow heavily. These were perceived by many as "going too far," as adding too much debt to (some) corporate balance sheets, as destabilizing the firm, making it riskier and more brittle. (To be sure, much evidence, maybe the weight of the evidence, was that the LBO's induced more efficient management.<sup>106</sup> But that's not the race point here: the theory point is that when it is important, the transaction attracts federal attention.)

LBO's might have been regulated via corporate law, and an adjunct to corporate law, fraudulent conveyance law did come into play.<sup>107</sup> But Federal authorities reacted as well, via the Federal Reserve's re-regulation of borrowing for corporate acquisitions.<sup>108</sup> The regulation had bite, and it was seen as "shot across the bow" for

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<sup>104</sup> IRC § 280G.

<sup>105</sup> IRC § 162(m).

<sup>106</sup> Steven Kaplan, *Federated's Acquisition and Bankruptcy: Lessons and Implications*, 72 WASH. U.L.Q. 1104 (1994); Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 J. FIN. 611 (1989).

<sup>107</sup> *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488 (Bankr. N.D. Ill. 1988).

<sup>108</sup> See, e.g., Federal Reserve, *Securities Credit by Persons Other than Banks, Brokers, or Dealers; Purchase of Debt Securities to Finance Corporate Takeovers*, 12 C.F.R. Part 207; Regulation G, Docket No. R-0562; *Purchase of Debt Securities to Finance Corporate Takeovers*, Regulation U, 12 C.F.R. § 221.124.

leveraging transactions: that if they went further, the Federal Reserve would react further.

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These two subtle incursions and four sharp federal incursions regulating going private transactions, mandating an all-holders rule, barring dual-class recapitalizations, and mandating how half of the country's shareholders treat their vote would be enough to see how federal law can displace state corporate law. But there's more, in the pervasive aspects of securities law in regulating of shareholder voting overall, in creating of quasi-fiduciary duties via insider trading and more, via subtle nudges and shifts in shareholder voice in the 1990s, and finally, via Sarbanes-Oxley, in taking central aspects of corporate governance away from the states.

3. *The structure of securities regulation.* Even putting aside specific transactions of recent decades, we clearly have two major sources of regulation of the large corporation in the United States, state corporate law and the securities law. Corporate commentators regularly point to the overlapping authority and the conflicts, and the courts try sometimes to separate out the two contesting authorities.

The legislative history of the 1934 Act is instructive. The first congressional report recommended full federal incorporation for firms in interstate commerce, not just a securities statute. While the pure-form of federal incorporation was not taken up, pieces of that plan entered the 1934 Exchange Act. Critics of the 1934 Act said that core provisions were really federal incorporation rules and should not be part of the statute.<sup>109</sup> They became part of the 1934 Act anyway, and people just stopped thinking of, say, voting and insider trading as internal affairs, so that the facts could be reconciled with the articulated internal affairs standard.

Consider voting: the wide system of proxy regulation from the SEC determines what goes into the proxy request to shareholders, what can get onto the ballot—such as corporate governance proposals that might fail under state law, who gets access to shareholder lists, and how a proxy fight (what could be more basic and internal?) is waged.

Or consider the corporation's and its officers purchase of stock from the corporation's stockholders: The corporation's and its officers' buying and selling of common stock was validated by the states at common law, and that state result was one of the bases for congress to pass the securities laws, to take regulation of insider trading in stock away from state corporate law and federalize it.

(a.) *The view in 1933 and 1934*—Delaware and the states were seen as not inducing adequate, modern information dissemination from the corporation to its shareholders. Indeed the states generally required no information dissemination. The annual election was considered sufficient to induce the incumbents to disseminate information *sua sponte*. Nothing more was needed, although little information was disseminated under state law.<sup>110</sup> With states defaulting on forcing information disclosure, the stock exchanges stepped in early. The first major disclosure effort in

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<sup>109</sup> LOUIS LOSS, *SECURITIES REGULATION* 109 (2d ed. 1961) [UPDATE].

<sup>110</sup> WILLIAM ALLEN & REINIER KRAAKMAN, *COMMENTARY AND CASES ON CORPORATE LAW* 7-43 (2002) (multilithed draft casebook).

the United States came in 1907, not from New Jersey or Delaware (the principal competing incorporators at the time), but from the New York Stock Exchange.<sup>111</sup>

And on other issue Delaware seemed deficient to Federal players. In the late 1920's Delaware amended its statutes, in a mis-timed act to allow corporations to waive some long-standing protections for shareholders, and to authorize directors to issue "blank stock whose full terms would be set later by the board."<sup>112</sup> Adolf Berle, an influential commentator of the time, "scathingly" attacked these acts as amounting to the "power of confiscation."<sup>113</sup> The point here is not to assess whether Delaware was racing to the bottom (or to the top), but that the Federal authorities reacted. (The Delaware provisions plausibly were sensible, but the provisions riled those who were listened to in Washington, and Delaware's acts contributed to a federal response.)

Disclosure to current shareholders (not just disclosure to external buyers) was federalized in 1934. Indeed, effectively all of corporate accounting has been federalized. It's done by the FASB, with input and influence from the SEC. When accounting controls fail, as in Enron and WorldCom, we look to Federal authorities to fix the problem, not to state corporate law.

(b.) *The vote*—Arguably the core of corporate law is the shareholders' vote. The view is now well accepted that the annual proxy solicitation is effectively controlled by SEC regulation, with state law having long faded to a secondary role. Hornbooks tell us: "SEC regulation is in fact so pervasive that ... the very structure of the proxy solicitation process is not only informed but dictated by SEC regulation."<sup>114</sup> Or that logically, "[i]n a more perfect world, proxy regulation would be handled in state corporation statutes."<sup>115</sup> The logic is there, but the reality is that the central act of shareholder control over the board—the annual election of the directors—is overwhelmingly a matter of federal, not state, law.

Why did the federal securities laws grab jurisdiction over the core corporate internal act? States were seen in 1934, we are told, as having done "virtually nothing to cope with the problem ... of [abuses in] the solicitation of proxies [for management]"<sup>116</sup>

Consider just one mechanical aspect: access to shareholder lists. That access was once considered less than satisfactory at state law.<sup>117</sup> SEC Rule 14a-7 requires the company to mail the insurgents' proxy statement for them, or furnish them with a list, a mechanical act that might have been solely regulated at state law. Combine Rule 14a-7 with Regulation 13G, which requires most major shareholders to publicly disclose their holdings, thereby allowing precise assembly of institutional shareholding lists, and we have nearly complete federal displacement of even the most mundane

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<sup>111</sup> Paul H. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

<sup>112</sup> Seligman, *supra* note 31, at 43-44.

<sup>113</sup> *Id.* at 44.

<sup>114</sup> ARTHUR M. PINTO & DOUGLAS M. BRANSON, *UNDERSTANDING CORPORATE LAW* 148 (1999).

<sup>115</sup> LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 116 (1998).

<sup>116</sup> Edward R. Aranow & Herbert A. Einhorn, *Proxy Regulation: Suggested Improvement*, 28 GEO. WASH. L. REV. 306 (1959).

<sup>117</sup> Cf. case-law outlined in the SEC Release, cited in note 118, *infra*.

mechanical aspect of state law: insurgents' access to shareholder lists. The SEC in its last early 1990s initiative on shareholder lists was direct, but polite, saying that it promulgated 14a-7 to reverse state law, and end the "*expense and delay requestors typically encounter [under state proceedings] in obtaining a securityholder list.*"<sup>118</sup>

Or another mechanical, internal voting rule: state law could allow managers to bundle proposals: by putting up a shareholder-friendly proposal (special dividend of \$X) with a less-friendly one (entrenching managers), the shareholder might approve. The SEC's 1992 proxy amendments require that the "proxy provide for a separate vote on each matter presented."<sup>119</sup> And similarly, the SEC allowed shareholders to "mix and match" in voting for directors, making it easier for them to elect a minority slate to the board.<sup>120</sup> These are all, by any functional view of the term, internal affairs.

(c). *Insider trading rules to displace state law*—Insider trading was effectively legal at common law.<sup>121</sup> The corporation and its officers could disclose or not, according to their pleasure. (Lack of privity meant lack of fiduciary duty.) This was seen as sub-optimal corporate governance, and the Federal authorities took over regulation of insider trading in 1934. The rules could have developed out of state agency law's ban on an agent using confidential information to make a profit. They could have developed out of fiduciary duty law. But they did not, and the insider trading rules are federal now.

(d). *Federal quasi-fiduciary duties*—Even fiduciary duties, perhaps the core of common law regulation of the corporation, were not free from federal incursions. In the 1960s and 1970s the explosion of 10b-5 liability was moving federal courts into all of the then-current corporate transactions. The Second Circuit was transforming what might previously have been state fiduciary duty issues 10b-5 fraud claims.<sup>122</sup> And other circuits were following. As Richard Jennings, a leading authority on securities regulation at the time, said in the mid-1970s: "most of the important litigation relating to corporate mismanagement and shareholder abuse is not conducted in ... the Delaware courts [any longer]. ... [N]o shareholder in his right mind will litigate a shareholder grievance in a Delaware state court if some other forum is available ...."<sup>123</sup>

Delaware's competition for the issues of the day came from the federal courts—"the flight of shareholder litigants from the state to the federal courts has been ... massive"<sup>124</sup>—and commentators thought that 10b-5 would soon govern sales of

<sup>118</sup> Exchange Act Release Number 34-29315, 56 FR 28987-01, at 28,997 (June 1991). Cf. id., at 28,994 n.63 (collecting state cases of lawsuits delaying shareholder access to the companies' lists. One might have thought that this too—a current shareholders' access to the internal corporate list of shareholders—would be an internal corporate affair. But, the SEC redefined this one too into an external affair. Id. at 29570 n.43 (access to "shareholder lists is not a matter subject to the regulation of the internal affairs of the corporation"). Elastic concept. Moving line.

<sup>119</sup> *Regulation of Communications Among Shareholders*, SEC Release No. 34-31326, 52 S.E.C. Docket 2028, Release No. IC-19031 (1992); Rules 14a-4(1) & (b)(1).

<sup>120</sup> Rule 14a-4(b).

<sup>121</sup> ALLEN & KRAAKMAN, *supra* note 110, at 14.1.

<sup>122</sup> *Drachma v. Harvey*, 453 F.2d 722 (2d Cir. 1972); *Poplin v. Bishop*, 464 F.2d 714 (2d Cir. 1972); *Schoenbaum v. Firstbank*, 405 F.2d 215 (2d Cir. 1968); *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967); *Levine v. Biddle Sawyer Corp.*, 383 F. Supp. 618 (S.D.N.Y. 1974)

<sup>123</sup> Jennings, *supra* note 41, at 997.

<sup>124</sup> Id. at 1000.



control, going-private transactions, corporate opportunities (which after all visited a type of fraud on the firm), self-dealing, and so on.<sup>125</sup> They so thought, that is, until the tide crested (and thereafter receded) with *Santa Fe v. Green*.<sup>126</sup> The point here is not that the federal authorities always take over, but that the possibility of their doing so affects Delaware, and often does so more than a state-to-state race affects it.<sup>127</sup>

And the influence continues today. To disclose an act is to control that act. Transactions might be banned under state law, but the mechanism that sorts out those that survive and those that fail is in large measure the mechanism of disclosure and the means of gate-keeping. These two are now largely done under the securities laws, not state laws. While the formal division of authority is said to be that the SEC is disclosure-forcing, trade-regulating, while Delaware and the other states handle the internal affairs of shareholder-director relations, there is more going on here. This is the formal division, but savvy lawyers, judges, and analysts know better. Much substantive law can be, and is, made in the name of disclosure. For many regulatory tasks, just making the transaction public is sufficient regulation to control it. To force disclosure “This company is run by thieves” is usually sufficient to shut down the practice, and, hence, *ex ante*, to keep the thieves out, a matter formally of internal affairs not disclosure, but one that can be, and is, effectively restricted as much by the federal disclosure statutes as the local state rules.

4. *Subtle shifts.* Even before Sarbanes-Oxley, one could detect shifts of authority in the corporation, shifts induced by federal rules.

(a.) *Reallocating power insider the corporation via shareholder voice*—Some micro-analysis of the SEC rules is here instructive. We need not analyze precisely every federal-state over-lap, but let us look carefully at one.

A core state law concept is that its board of directors manages the business of the corporation; corporate lawyers just refer to this as Delaware § 141.<sup>128</sup> Shareholders cannot call in directions to the board on business strategy and plans. The board is primary.

But consider the evolution of the SEC's Rule 14a-8. The SEC allows, notwithstanding state law, that shareholders get access to company's proxy solicitation under Rule 14a-8. The SEC's own exclusions though were historically so large that the rule was for decades not a governance tool, but a mechanism for social protest:<sup>129</sup>

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<sup>125</sup> Stanley A. Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUSINESS LAWYER 883 (1976); Boyer, *supra* note 27, at 1054.

<sup>126</sup> 430 U.S. 462 (1977). *Santa Fe* ought not though to have lifted fear of federalization from the states., as it explicitly invited *congress* to act: “There may well be a need for uniform federal fiduciary standards to govern mergers,” said the Court, “[b]ut those standards should not be supplied by *judicial* extension of Section 10(b) and Rule 10b-5 to ‘cover the corporate universe.’” 430 U.S. at 479-80 (emphasis supplied).

<sup>127</sup> Joel Seligman, *The New Corporate Law*, 49 BROOKLYN L. REV. 1 (1993); ALLEN & KRAAKMAN, *supra* note 110.

<sup>128</sup> Del. Gen'l Corp. L. § 141.

<sup>129</sup> *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970) (Dow Chemical and napalm), vacated for mootness, 404 U.S. 403 (1972); *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416 (D.C. Cir. 1992); *NYC Emp. Retirement System v. SEC*, 843 F. Supp. 858 (S.D.N.Y. 1994) (Cracker Barrel discrimination); Nike Inc. SEC No Action Letter, 1997 WL 384740 (July 10, 1997).

proposals on corporate structure or the allocation of authority between directors and shareholders were excluded. Nothing could get onto the company's proxy solicitation that dealt with ordinary management of the corporation.<sup>130</sup> Nothing could get in that was improper under state law; this ban thus respected Delaware § 141—that the business of the corporation is to be managed by the board: no policy initiatives from the shareholders, the board reigns.<sup>131</sup>

But in a subtle 1990s shift, the SEC has forced managers to give access to their proxy statement to shareholders' "precatory" proposals on corporate governance. In its *Waste Management* decision, the SEC forced management to accept a proposal on increasing the independent directors on the board, and there since have been a slew of anti-poison pill measures and anti-staggered board precatory votes.<sup>132</sup>

One might cynically think this just lets off shareholder steam. That might be right. And boards could ignore their shareholders' "precatory" vote, as some have. Or one could see this as the SEC pressing into the territory formerly governed exclusively by Delaware Gen'l Corporation Law § 141: if the proposal is precatory, the shareholders vote, and the board might be wary of ignoring a shareholder vote. Voice is not direction, but it is a means to power; and the SEC by enhancing shareholder voice has subtly shifting the shareholder-board balance otherwise drawn by Delaware § 141.

(b.) *Gate-keeping and whistle-blowing as federal corporate governance*—Corporate governance is often about gate-keeping: Before the corporation acts, must it get a certification from an outsider, from a professional whose reputation (and liability) is on the line? Gate-keepers include the company's attorneys, its accountants, its underwriters, and so on.<sup>133</sup> The SEC regulates gate-keeping and gate-keepers closely. The detail is best left out here, but each of the main gate-keepers need to be conscious of their responsibilities under federal law, and maybe less so under state law.<sup>134</sup> To impose a duty on lawyers or accountants to bring the perceived wrong-doing up the corporate chain of command is to control the substantive act. It is internal corporate governance. And it is Federal law, not state corporate law.

Consider one prong in the federal response to the Enron and WorldCom scandals. The Sarbanes-Oxley Act of 2002 requires the SEC to make rules requiring attorneys representing securities issuers to report evidence of material securities law violations to the company's chief legal officer or chief executive officer. And if either "does not appropriately respond (adopting ... remedial measures or sanctions with

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<sup>130</sup> Exchange Act Rule 14a-8(i)(7).

<sup>131</sup> Exchange Act Rule 14a-8(i)(1).

<sup>132</sup> SEC No-action Letter to Waste Management, 1991 WL 178585 (Mar. 8, 1991) (staff refuses no-action letter when Waste Management seeks to exclude shareholder proposal on independent directors); *Int'l Brotherhood of Teamsters Gen'l Fund v. Fleming Cos*, 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan. 24, 1997) (poison pill shareholders' proposal properly included in the proxy statement); ALLEN & KRAAKMAN, *supra* note 110, at 7-54 to 58.

<sup>133</sup> Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984).

<sup>134</sup> See *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978); *In re Carter*, Exchange Act Release No. 17,597 (Feb. 28, 1981).

respect to the violation),” then the lawyer must go to the board’s independent directors, the board’s audit committee (which must be independent under a separate directive) or the entire board.<sup>135</sup> The violations for which the lawyer now becomes a serious gatekeeper are not just securities law violations, but *any* “breach of fiduciary duty or similar violation.”<sup>136</sup> These are internal affairs, and this is a federalization of the corporate control of state fiduciary duties.

Auditors are under similar and stronger duties: to report violations of law first to senior management, and if management responds unsatisfactorily, to go to the board and the SEC as well.<sup>137</sup> And internal control systems (what affair could be more internal?): Judge Allen recognized that with the Federal sentencing guidelines from 1991, the balance of internal controls had changed: The guidelines give a big break to corporations with effective compliance programs in place. And Allen in *Caremark* rests his analysis on whether the defendant company had that kind of a system in place. It did not. They should have, and Allen effectively over-turned earlier Delaware authority. In *Allis-Chalmers*, managers violated the antitrust laws, severely damaging the company. Held the court: no obligation for an internal compliance system; no gross negligence liability of directors. What had happened in the interim? Partial federalization of the reasons to have internal corporate systems, via the federal sentencing guidelines.<sup>138</sup> And in 2002 the rules on internal control systems were made explicit, not piggy-backed to federal sentencing guidelines: Sarbanes-Oxley mandates that management assess the control systems and represent that they’re adequate for the company’s business.

(c.) *Creeping preemption*—And in the 1990s, a shift little-noticed<sup>139</sup> but one would suspect vivid in Delaware: The federal securities laws repeatedly have savings clauses, affirmatively saving parallel and supplementary state rules and remedies. But in the late 1990s Congress in rapid-fire succession passed the National Securities Markets Improvement Act of 1996 and the Securities Litigation Uniform Standards

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<sup>135</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745 (2002). Note the standard is “has evidence,” not “knows.” The lawyer cannot any longer easily avoid responsibility because his or her information does not rise up to the level of actual knowledge.

<sup>136</sup> Sarbanes-Oxley, § 307. And the Act bars firms from retaliating against employees who help outside investigations. Sarbanes-Oxley, § 806.

<sup>137</sup> Private Securities Litigation Reform Act of 1995, Exchange Act § 10A.

<sup>138</sup> *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963). Ex ante the violations were plausibly good for shareholders if the odds of non-detection were low. A rule inducing an internal compliance system—the effect of *Caremark*, prodded by the Federal sentencing guidelines—induces compliance, not shareholder profit. It makes corporate law serve a purpose other than that of shareholders or managers, strengthening enforcement of non-corporate law.

<sup>139</sup> But see Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215 (1999), for a nice analysis cognizant of the sharp federalization entailed by these acts, which “reversed six decade of legislative policy [of deference to the states]. ... [There had been a] longstanding [federal] tolerance for parallel state law... . [State securities protections] provoked [no federal response until] Congress in 1996 and 1998 ... preempted [these] states law[s].” Id. at 229. The “division between corporate governance and regulation of [securities] market transactions has blurred [and] ... seems difficult to preserve.” Id. at 221-22. By undermining the “division between federal and state regulation. ... [Congress,] ... [via] the 1998 Act ... prevent[ed] any ... state rule more favorable to shareholders ... [, taking] another large step toward a federal corporations law.” Id. at 242.

Act of 1998,<sup>140</sup> laws that not only reject traditional savings clauses (that respect parallel state law) but explicitly eradicate contrary state law:

[N]o law, rule, regulation, or order, or other administrative action of any State, or any political subdivision thereof ... shall directly or indirectly apply to ... a covered security.<sup>141</sup>

Congress explicitly understood the race (to the top or bottom) issues, and squelched the race:

Without a national standard ... the potential threat is always there that one [s]tate will change its laws in such a way as to become the haven for [such] litigation. This almost happened in California last year ....<sup>142</sup> Congress was seeking not to end state-to-state confusion but to preempt particular state law.<sup>143</sup>

The point again is not that federal law is necessarily improving upon state law-making that raced to the bottom. The merits of the federal preemption—and of the substance of the statute itself—are debatable. The point is that states in general, and Delaware in particular, cannot just look to other states as their competition. Federal authorities can trump the state race, and they do. The 1990s preemptions did.

*5. Dropping pretense: Sarbanes-Oxley.* This was all true before Sarbanes-Oxley, and Sarbanes-Oxley does not even pretend to stay on the disclosure/trading side of the division of power, not even offering up rhetorical respect for state rules governing the corporation's internal affairs. It digs deep into corporate governance, regulating the nitty-gritty. In reaction to the Enron-class scandals, Congress mandated structures and responsibilities. States were perhaps perceived as having been lax on controlling the internal structures—consider Delaware's General Corporate Law § 102(b)(7), which along with its 40-odd state followers facilitated the wholesale dropping of board liability for duty of care violations—so Congress would mandate what firms must, and must not, do.

Some Sarbanes-Oxley rules may not be well-considered: several babies may have gone out with the bath-water. The Act's flat ban on company loans to officers,<sup>144</sup> if literally interpreted, means that firms cannot lend funds to relocating new CEO's,

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<sup>140</sup> Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C. §§ 77-78).

<sup>141</sup> 11 U.S.C.A. § 77r (West Supp. 1999). The drafters knew exactly what they were doing, as they replaced the contrary understanding, deleting from the statute:

Nothing in this subchapter shall affect the jurisdiction of the securities commission ... of any State ... over any security or person.

15 U.S.C. § 77r (1994 (repealed 1996)). Congress with these two laws sought to cut-back State remedies for losses in sales of corporate securities.

<sup>142</sup> *Securities Litigation Uniform Standard Act of 1997: Hearings on S. 160 Before the Subcomm. On Sec. Of the Sen. Comm. On Banking, Housing, and Urban Affairs*, 105<sup>th</sup> Cong., -- Sess. 15 (1998) (statement of Sen. Dodd). Cf. *id.* at \_\_, the testimony of Daniel Cooperman, Senior Vice President, Oracle Corp.: "As nationally traded companies in a global marketplace it simply makes no sense for there to be fifty different state laws applying to the buying and selling of securities."

<sup>143</sup> Thompson, *supra* note 139, at 232. Congress ought to oust California here, not Delaware.

<sup>144</sup> Sarbanes-Oxley § 402(a).

could not lend officers money to buy the company's stock, etc. Delaware's express rule was (and is) to the contrary—"[a]ny corporation may lend money to ... any officer of the corporation ... including any officer ... who is a director ... whenever, in the judgment of the directors, such loan ... may reasonably be expected to benefit the corporation"<sup>145</sup> and it may be the better rule. But the point is that the federal behemoth took over the issue, squelching the states with substantive federal law, effectively wiping out Delaware's statute specifically permitting loans to executive officers.<sup>146</sup>

Sarbanes-Oxley mandates that the SEC issue rules requiring audit committee independence.<sup>147</sup> It controls compensation by requiring that a class of bonuses be forfeited if the company goes bankrupt.<sup>148</sup> It mandates that the audit committee control the hiring and firing of accountants, and the ancillary business that the accountants do with the corporation.<sup>149</sup> It mandates rotation of audit partners, and pushes toward rotation of the accounting firm.<sup>150</sup> It orders the SEC to grab control of off-balance sheet transactions and special purpose vehicles.<sup>151</sup> It sets up the possibility of federal control of who may and may not sit on a corporate board.<sup>152</sup> Once these matters were for state law. No more. Now federal authorities, not the state legislature, not the state courts, and not the board of directors regulate them.<sup>153</sup>

6. *Delaware's origins in the first federalization.* It's not just modern, and it's not just Sarbanes-Oxley in 2002. A hundred years ago, the late 19<sup>th</sup>- and early 20<sup>th</sup>-century state-to-state race mixed antitrust and corporate law mandates in a way that would today seem odd. That is, we have separate categories now for antitrust and corporate law, and separate regulatory domains. This separation though did not prevail from the 1880s through about 1915 or so. When we trace out the interaction here between antitrust and corporate law, and state and federal law, we see that the federal government first considered taking everything away from the states (since the issues were mixed and it sought to control some of them), and eventually took away antitrust, severing the two categories.<sup>154</sup>

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<sup>145</sup> Delaware Gen'l Bus. Corp. L. § 143.

<sup>146</sup> Section 402 of Sarbanes-Oxley is a flat bar, precisely opposite from Delaware's rule:

Prohibition on Personal Loans to Executives—It shall be unlawful for any [public company] to extend ... credit, to arrange for the extension of credit ... in the form of a personal loan to or for any director or executive officer ... of that issuer.

Whether this ban will last is open to question: repeal or interpretive demise seems plausible. The term "personal" loan may give regulators and lawyers an opening. The point is that Congress was, and is, ready to act, even on details of corporate internal governance.

<sup>147</sup> Sarbanes-Oxley, § 301.

<sup>148</sup> Sarbanes-Oxley, § 304.

<sup>149</sup> Sarbanes-Oxley, § 204.

<sup>150</sup> Sarbanes-Oxley, §§ 203, 207.

<sup>151</sup> Sarbanes-Oxley, § 401.

<sup>152</sup> Sarbanes-Oxley, § 305, barring "unfit" directors.

<sup>153</sup> In parallel action, the NYSE displaced state regulation elsewhere, requiring that a majority of the directors of NYSE-listed companies be independent.

<sup>154</sup> Even as late as 1933, Brandeis still thought the race was an antitrust race. That is, Brandeis' well-known characterization of the states as racing the bottom, quoted *supra* in text accompanying note 9, was about *antitrust* considerations, *not* pro-shareholder corporate rules.

For example—and this is not trivial to the concept or the federalization issues—when the Ohio Attorney-General attacked Standard Oil, he did so on a mixture of antitrust and corporate authority. Standard Oil had pulled the oil industry into a anti-competitive structure via a set of trust arrangement: the Standard Oil trust in New York held the stock of most of the American oil industry. Standard Oil's entry into the trust arrangement was ultra vires the Ohio corporation, he argued to the Ohio courts. It was ultra vires because such an action—a restraint on trade—was not something the Ohio legislature would have authorized Standard Oil to do in its charter, and Standard Oil's authority came from its charter. The Ohio Supreme Court agreed and ordered the trust dissolved.<sup>155</sup> Why had Standard Oil entered into the trust? Its cartel was unstable, for normal cartel reasons. (Cartel members agreed to cut production and raise price, but when they saw the attractive price they increased production. The increase in production—i.e., the increase in competition—then lowered price. The cartel tended unravel.) Standard Oil would have liked simply to acquire the oil companies with which it had entered into the trust arrangement, but Ohio corporate law did not authorize it to acquire the stock of another non-Ohio corporation. (Not just Standard Oil was involved: other trusts were under similar attack from other states. The Cotton Oil Trust—a big trust operation at the time—was organized in 1884 to process cottonseed oil and sell the byproducts of animal feed, fertilizer, and soap.<sup>156</sup> Tennessee and Louisiana attacked the trust, and their courts sought to shut the trust down.<sup>157</sup>)

New Jersey became the mother of trusts largely because it authorized New Jersey corporations to acquire the stock of non-New Jersey corporations, thereby facilitating organizing monopolies as holding companies rather than as trusts. Usually this is presented as New Jersey modernizing corporate law, by making it more flexible.<sup>158</sup> This it did—the claim is accurate—but the issue *at the time* was not ordinary management, but monopolization. And monopolization was so important that the federal authorities eventually took away part of the then mixed-issue of antitrust and corporate law from the states.

This can be properly seen as a state-to-state race at first: states raced to provide flexible terms that would facilitate Standard Oil's monopoly. (Ironically, this was good for its shareholders, bad for the public). New York was approached, but refused. New Jersey, with a budget problem, and more susceptible to private influence on the

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Brandeis' lead-in sentence was: "The removal by the leading industrial states of *the limitations upon the size and powers of business corporations* appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself but to the conviction that it was futile to insist upon them." 288 U.S. at 557-58. Brandeis was speaking of the states willingness to allow corporate growth, and to give the corporations the means to monopolize, means that he opposed. The states were actually provided pro-shareholder rules, by facilitating monopolization.

<sup>155</sup> *State of Ohio v. Standard Oil Co.*, 49 Ohio St. 137, 30 N.E. 279 (1892). More precisely, it ordered the Standard Oil of Ohio—the key players in the trust—to drop out.

<sup>156</sup> ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 326-27 (1977)

<sup>157</sup> *Mallory v. Hanour Oil-Works*, 86 Tenn. 598 (1888). See Stephen Marshall, *New Jersey and the Trusts, 1888-1896: The Birth of Modern Corporation Law* (Dec. 6, 1988 Rutgers working paper).

<sup>158</sup> E.g., ALLEN & KRAAKMAN, *supra* note 110, at 4-6.

legislature at that time, acceded.<sup>159</sup> So New Jersey passed its first pro-monopoly corporate law in 1889, and continued to make its corporate laws easier for the trusts in the 1890s.<sup>160</sup> A year after New Jersey's first corporate law liberalization for the monopolizing firms, Congress passed the Sherman Act, formally taking away the authority New Jersey had bestowed on the corporation to enter into one type of combination (the interstate corporate merger) in restraint of trade. It remained to be seen how the act would be enforced, but if effectively enforced all that the federal government left the states was (relatively less important) authority to regulate non-monopolizing mergers. Not trivial, but not the core issue of the time.

And then the Delaware-New Jersey race began: New Jersey made monopolization mechanisms easy, as long as the federal authorities were silent under the Sherman Act. Delaware copied the New Jersey rules, but firms were happy enough with New Jersey that they did not move. Then, two decades later, Woodrow Wilson as Governor sought to take away the flexibility, because New Jersey should not be the mother of trusts. Wilson attacked monopoly, not corporate flexibility. Reformers had excoriated New Jersey's corporate law as facilitating national monopolies, and Wilson agreed.<sup>161</sup> He campaigned against monopoly (not flexibility) when he ran for governor in 1910, although he made no proposals to the legislature during his first years as governor. But then in the 1912 Presidential election, Theodore Roosevelt taunted Wilson for being an ersatz reformer, when he, Roosevelt, had busted up trusts. So in Wilson's 1912 message to the state legislature he acted: "*The corporation laws of the State notoriously stand in need of alteration. They are manifestly inconsistent with the policy of the Federal government. ... The laws of New Jersey, as they stand, so far from checking monopoly actually encourage it. ... We should act upon them at once.*"<sup>162</sup> The core element was a local antitrust act: making it illegal for a corporation to acquire a monopoly, limit production, fix prices. Thereafter, New Jersey repealed its corporate law authorization for holding companies, the means for monopolization. New Jersey corporations lost authority to buy the stock of competitors.<sup>163</sup>

And Delaware then grabbed the business. New Jersey was shutting the antitrust barn doors after their authority had already fled the states: By the time Wilson induced the state legislature to act (after the 1911 *Standard Oil* decision meant real Federal antitrust action), the big antitrust authority was removed from the states, and all that

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<sup>159</sup> Harold W. Stoke, *Economic Influences Upon the Corporation Laws of New Jersey*, 38 J. POL. ECON. 551, 571-72 (1930).

<sup>160</sup> Stoke, *supra* note 159, at 572-74; Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1919*, 49 J. ECON. HIST. 677, 681 (1989).

<sup>161</sup> Lincoln Steffens, *New Jersey: The Traitor State*, MCCLURE'S MAGAZINE, May 1905, at 46-47.

<sup>162</sup> Stoke, *supra* note 159, at 578 (1930) (emphasis supplied); William E. Kirk, *Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-eminence*, 10 J. CORP. L. 233, 255-56 (1984).

<sup>163</sup> Stoke, *supra* note 159, at 578. We could speculate that when the federal government fully federalized antitrust, there was less revenue for New Jersey to extract from the monopolies via the franchise tax. The New Jersey charter was rendered less valuable. And hence the chartering business was rendered less valuable for New Jersey. It could more easily indulge in being public-spirited in denying the then-perceived tools of monopolization.

the federal authorities left to the states was corporate flexibility. But presidential debates between Roosevelt and Wilson are not as accurate as we can be on the 1912 efficacy of state corporate law in combating the trusts, and action followed the contemporaneous perception.

That this was then a mixed issue of antitrust and corporate law was well-understood at the time,<sup>164</sup> although it usually disappears from today's accounts.<sup>165</sup> The federal authorities took the big stuff away—the mechanisms that would strongly affect profits and capital costs—leaving the smaller mechanics for the states.

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And so we see a history of repeated federal intervention—actual or threatened—in corporate law-making. Whether it was the early mixed issues of antitrust and corporate reorganization, or the 1930s issues of shareholder voting and insider trading, or the 1960s issues of going private, or the 1970s issues of fiduciary duties, or the 1980s takeovers, or the early 21<sup>st</sup> century issues of scandals and effective internal governance, the federal government has been a player in the key corporate issues of the day.

In each case one could argue that the federal ouster (or threat thereof) was “special,” so important to the national economy that the “normal science” of corporate decision-making and state racing could not continue. But that is exactly the point: when the issue is truly important, federal ouster happens, or is threatened. Delaware cannot look just to the other states when it confronts a big issue, but to Washington, where its most important competitor sits.

#### IV. THEORY: WHY THE UNITED STATES HAS NOT HAD, AND CANNOT HAVE, A TRUE RACE

##### A. An Inconclusive Academic Debate?

Fine minds have argued the states race to the top. And fine minds have argued states race to the bottom. And data has been brought forward to prove states race to the top;<sup>166</sup> data has been brought forward to show that states race to the bottom.<sup>167</sup> The debate seems stalemated, and the perspective here of an omnipresent federal trump helps to explain why the debate has been and must be inconclusive. Because key

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<sup>164</sup> Note, *Little Delaware Makes Bid for the Organization of Trusts*, 33 AM. L. REV. 418 (1899).

<sup>165</sup> Cf. Kahan & Kamur, *supra* note 3; ALLEN & KRAAKMAN, *supra* note 110, at 4-6 (“New Jersey’s statutes had many innovations ... permit[ing] the holding company structure, which, in turn, made possible corporate joint ventures and networks of corporations related by ownership, sometimes called corporate groups.”)

<sup>166</sup> See Daines, *supra* note 1; Romano, *supra* note 8.

<sup>167</sup> Compare Lucian Bebchuk, Alma Cohen & Allen Ferrell, *supra* note 2; Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charters* (Harvard Law School working paper, 2002); and Lucian Bebchuk & Alma Cohen, *supra* note 79, with Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Romano, *supra* note 8.



decisions have been removed, or have faced the threat of removal, we cannot tell whether the big ones that remained and are efficient were shaped by good federal influence (because the federal government is the custodian of the American economy) or whether the big ones that remained and are inefficient were shaped by pernicious federalism (because the federal government has a monopoly position, unaffected by interstate competition but susceptible to error and to influence from interest groups, and can accordingly impose inefficient corporate decisions that raise capital costs).

And it must be inconclusive because we live in a federal system. Absent, say, a constitutional amendment barring federal involvement in corporate affairs, the federal government can determine, will determine, and has determined critical elements of corporate governance. The current state of affairs—a tradition of deference to state regulation of corporate affairs, a tradition that is breached only when it seems very important to federal actors—is the most deference that the federal government can realistically give. And with that level of deference, Delaware corporate law theoretically must be, as it has been, subject to influence and ouster by the federal authorities, thereby rendering any true race to the top impossible in fact, however attractive it might be in theory.

## B. The Impossibility of Interstate Race-to-the-Top Theory

Let's say we have conclusive evidence that the dominant incorporating state has produced efficient corporate law. That evidence would not, and could not, be conclusive on whether state competition in corporate chartering is efficient. We would not know whether the federal threat made it efficient. Was Delaware prepared to race to the bottom, but did fear of SEC ouster on that issue make it come out right?

We have some organizational theory parallels on which a new theory of the production of corporate law might be built. Decisions are said to improve if the process of proposal is separated from the process of ratification, if we have two separated decisions, by different decision-makers, e.g., managers propose, the board ratifies.<sup>168</sup> And we have the corporate theory that efficiency was enhanced by having decentralized managers run the firm day-to-day, subject to review, veto, and overall strategic planning from the centralized and separated headquarters.<sup>169</sup> Similarly, one might begin a new theory with the view that the federal authorities do little if nothing seems badly askew in corporate results or Delaware law. But if one of these deteriorates badly, the federal authority intervenes: state autonomy for the most part, but not complete insulation.

So it could still turn out that we have a "genius" of American corporate law,<sup>170</sup> but not one as conventionally understood. Several of the Federal "interventions" seem

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<sup>168</sup> Cf. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303-04, 308 (1983).

<sup>169</sup> This was called the M-form corporation and had its theoretical heyday during the age of the conglomerates, until the conglomerates fell from favor. See OLIVER WILLIAMSON, *MARKETS AND HIERARCHIES* (1975).

<sup>170</sup> This is Roberta Romano's well-known description of the interstate chartering race, in her book of the same title: ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

to favor shareholders overall, and a serious evaluation might conclude that at the current level of Federal influence, Federal authorities have induced better corporate law. That would not necessarily mean we would want more intervention, in a way that would shut down all state law-making, and deny the system the benefit of experimentation. Discovering that we have an optimal level of Federal intervention might induce players to go for more, to test the limits, and that might demean the quality of law overall. But if Delaware does in fact produce law that is good for shareholders, we cannot tell whether it did so due to federal pressure or due to state competition.

### C. The Necessary Indeterminacy of the Race-to-the-Bottom

Suppose the contrary, that Delaware corporate law is demonstrably inefficient. Would we then know that Delaware raced to the bottom? We would not, because we would not know whether Federal politics would have produced bad law, due to, say, populist outrage or interest group maneuvering or congressional sloppiness. And Delaware might have concluded it had to do the “wrong” thing, because otherwise the federal authorities would take it away from Delaware.

One general possibility: Proponents of Delaware's advantages point to Delaware's fine judges. Yet, analysts also point out the fuzziness of many decisions that do not yield a firm rule (“facts and circumstances”), but fulminate against breaches of fiduciary duty (but do not hold liability). This federal competition theory can help explain the fuzziness: If one is uncertain of what the politics will be (or is) in Washington, better to be fuzzy and immunize oneself from harsh criticism from taking an unpopular stand. So, a strong anti-managerial stand in takeovers might motivate the managers to petition congress. But a strong and clear anti-shareholder stand might motivate the SEC (at least in the 1980s) to promulgate new rules or to go themselves to Congress. So better to be fuzzy, to be reasonable, and to lay low. And when one actually decides, zig-zag from decision to decision, so as not to offend any of the federal players that might react and attack. And only come to rest with a strong position when it is clear that the federal authorities (all of them) have lost interest, or it becomes clear that they are all pointing in the same direction as you are.

The problem is even harder. Imagine that there's a “right” balance between rules that give managers discretion and rules that limit managers discretion. Of the, say, ten rules that matter, they all should be somewhere in the middle, or five should confine managers and five should give them much discretion. Let us say further that we observed the dominant state *always* giving managers discretion. Since we know that the “right” balance is somewhere in between, we might falsely conclude that the states have raced to the bottom, in that area where the Federal authorities had left them discretion.

But we could not properly reach that conclusion. Ten rules matter. The states with residual authority over five of them give managers exactly what they want on those five. But if the other five Federally-set rules all *confined* managerial authority, then, since the right and efficient result is a 50-50- mix, the state were, on a system-

wide basis, efficient and racing to the top, despite that locally they overly favored managers and *appeared* to race to the bottom.

To decide that states raced, and would race, to the bottom, we would have to know what they would do if they could control the entire mix. But this is something that in a federal system, with an active central law-maker, we cannot know.

#### D. Revising the Race with a Federal-State Model

American corporate law has produced in a model more complicated than a pure state race. Understanding that there cannot be a pure race, that the Federal behemoth looms large in much state decision-making, does not mean that there is not state variation. States may compete, but the stakes are lower than is usually thought. In effect, the states can race, to the bottom or the top, only when the Federal authorities leave the field, and convincingly display no interest in coming back into the field, or when the states know that there is a “band” in which they can maneuver without provoking any Federal reaction.

To see how the model must be complicated than a simple state-to-state race, let's take a Delaware perspective here; and let's take the Delaware state-by-state race seriously. Delaware then we see can find itself in a bind: It can end up fighting a two-front war, and from time-to-time has. First, in the traditional model, it competes with other chartering states for the charters. But, second, it also competes with the Federal authorities in making corporate law. And its two main competitors have differing motivations, which do not always lead to the same substantive result. (In fact, Delaware might at times fight a three-front war: bigger states with local interest groups have differing goals than both Delaware and the Federal authorities. So, during the 1980s Rust Belt states plausibly were ready to protect local managers and local labor from takeover-induced disruption, irrespective of the effect on local corporate chartering revenue; they were less sensitive to the Federal magnetic pull, because chartering revenue was unimportant to them.)<sup>171</sup>

#### E. Taking the Long View

If we step back from any particular state act to take the big picture view, we can see Delaware as engaged in something more important than a state-to-state race. Begin our big picture view a quarter of a century ago in the 1970s. Delaware was perceived as badly protecting shareholders in the prevailing transactions of those times. Federal players consider displacing Delaware with Federal incorporation; Cary lambasts the pygmy and the SEC attacks Delaware's going private rules. Delaware

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<sup>171</sup> That states sometimes, as today, do not compete directly on chartering—the thesis in Kahan & Kamar, *supra* note 3—does not eliminate the state “front” in the war: Contestable market theory tells us that Delaware could have room to maneuver as a quasi-monopolist, but could lose the business if it badly mis-steps. Second, some states, maybe many states compete in different dimensions, such as local corporate social policy, employment, managerial protection, etc., not on corporate chartering. The authors recognize the second point, and the first point I make in a little more detail above, at note 15.

adjusts, to the point that by the early 1980s it is not seen as an attractive place for reincorporation, due to the moralizing tone and substance of its court decisions,<sup>172</sup> culminating with Delaware's 1985 *Van Gorkom* attack on American management. State competition seems subdued; the Federal threat shaped Delaware law much more. Only after *Van Gorkom* does the possibility of reincorporation out of Delaware turn substantial, and Delaware becomes less more solicitous of management, via, say § 203.

At the same time, Delaware could not move to be fully pro-managerial in takeovers because the Federal government was either pro-takeover (the SEC and the executive branch generally, and the judiciary until Schreiber and *CTS*) or moderate (Congress via the Dingell-Markey bill that would have barred key defensive measures like the poison pill). So it hedges and zig-zags. *Unocal* validates only "proportionate" defensive measures. *Moran* allows the pill to ward off coercive bids and says a close look on "yanking the pill" will be had, and Revlon promulgates tough auction rules. Then the Federal players leave the scene. First the courts with *CTS*, then Congress, and eventually (although later) the SEC via personnel changes. By the 1990s, drafters of state anti-takeover legislation were appointed to the SEC, and the toughest pro-takeover commissioners had left. The *Paramount* decision, close to "just say no" for management stands, and the Federal pressure to push it back is gone.

And then in the 1990s Delaware breathe freely free from Federal pressure, and observers see stability in Delaware's anti-takeover rules. Federal pressure on Delaware in the 1990s was weak (relative to its weight in the rest of the 290<sup>th</sup> century). Congress, after it abandoned a takeover law project by the late 1990 was quiet. The SEC had few new initiatives after the 1992 proxy reforms. Conservative courts were deferring to the states, not using securities law to expand federal governance authority. Delaware could garner more of the reincorporation business as federal incorporation (the 1970s issue is off of the table), and the data show an accelerating trend in Delaware garnering the reincorporation business.<sup>173</sup>

But that era came to an end with Enron. With Sarbanes-Oxley, the Federal authorities are back in motion, and Delaware has every reason to once again be conscious of the possibility, and already in several dimensions the reality, of ouster and federalization. One would expect Delaware corporate institutions to start to get "tough" just as they did in the late 1970s and early 1980s. Some observers detect that movement already.<sup>174</sup>

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<sup>172</sup> See Coffee, *supra* note 93 & accompanying text.

<sup>173</sup> Bebchuk & Cohen, *supra* note 79.

<sup>174</sup> Lawrence Lederman, Robert S. Reder & Gene Boxer, *A Blow for States*, THE DAILY DEAL, Oct. 25, 2002: "Perhaps Pure Resources represents [Vice Chancellor] Strine's effort to regain some momentum for the state in corporate governance. Ironically, the vice chancellor strikes his blow by incorporating various aspects of federal tender offer regulation—board recommendations and disclosures—into the requirements for a transaction state statute does not specifically address." The authors are corporate lawyers. The lawyers' analysis is of *In re Pure Resources, Inc.*, 2002 WL 31300797 (Del. Ch. Oct. 7, 2002).

## V. EUROPE

Two important initiatives have moved the race theory from the American to the international stage. In Europe, the *Centros* decision, the most famous corporate decision to come out of the European Union, sets Europe up for an inter-jurisdictional corporate race, one between the EU member nations. The European analysis focuses on the parallels to the American race debate,<sup>175</sup> with some looking, or hoping, for a race to the top, and others fearing a race to the bottom.

At the same time, an academic debate has erupted in the United States on whether securities law should be governed by a race—i.e., whether to allow an American issuer decide to be bound by French securities law, without moving to the jurisdiction or issuing securities there.<sup>176</sup>

The European discussions take the American race debate at face value. But the United States does not have, and cannot have, a pure interstate race. So those who look to international competition in securities regulation cannot point to the American race as a parallel, because the securities regulation competition would not have a centralized vetoing institution. And those who analyze the EU's *Centros* debate need to understand that the full parallel brings Brussels—the EU centralized decision-maker—into the picture. If Brussels is effective, defective or ineffectual, then that affects the race. For the Europe and American parallels to be kept, Brussels must be as good or bad as Washington. Europe has reason to focus as much on having an effective but not heavy-weight Brussels as it should on the fineries of inter-jurisdictional competition. But it is the latter that seems to have thus far occupied analytic attention. The European Union structure—of a centralized corporate authority with the capacity to trump the “local” national authorities is in fact the structure—withstanding the rhetoric of state-to-state racing—that the United States has had all along.

## CONCLUSION

The reality of American corporate law making is that if the issue is important, Federal authorities either take it away from Delaware or threaten to do so. Delaware players have reason to fear that if they mis-step, the Federal authorities (congress, the courts, the SEC) will enter the picture. If Delaware players appear to damage the

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<sup>175</sup> See the discussion in Eddy Wymeersch, *Centros: A Landmark Decision in Company Law*, in *CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW* 629-54 (Theodor Baums, Klaus J. Hopt & Norbert Horn eds., 2000). Cf. Barabara Trefil, *European Company Law: Comments and Meta-comments on Centros*, 2 *GERMAN L.J.*, at ¶7 (Dec. 2001);

<sup>176</sup> Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359 (1998); Stephen Choi, *Regulating Investors not Issuers: A Market-Based Proposal*, 88 *CAL. L. REV.* 279 (2000); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 *S. CAL. L. REV.* 903 (1998). Skepticism for the idea can be found in Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 *THEORETICAL INQUIRIES IN LAW* 649 (2001); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice in Note Investor Empowerment*, 85 *VA. L. REV.* 1335 (1999).

economy, public-spirited law-makers in Washington react. If they offend a powerful interest group too much, and that group lacks clout in Delaware, the group turns to Washington. As such, the United States has not had, and cannot have, a pure interstate race.

If American state-made corporate law is good, one cannot necessarily conclude that the good result is due to state competition, because side-by-side with any horizontal state competition is the vertical power of the Federal government. And if the state results produce bad corporate law, we cannot tell whether the states are mirroring defective decision-makers in Washington.

The instances of Federal ouster are just too many to be ignored. Hardly a decade went by in the 20<sup>th</sup> century without a major shift of corporate law-making, or the threat of one. Federal incorporation dominated the debate in the early 1900-1910 era, and then again in the early 1930s. It came back in the 1970s, mostly in the form of Cary's famous proposal for minimal federal standards. The securities laws in the 1930s took voting away from the states, took insider trading away from the states, and mandated information delivery to shareholders because the states had done nothing about it. Micro-matters were reversed by federal authorities: the going private rules were partially federalized and the SEC's actions and rhetoric provoked a Delaware reversal; state law allowed selective buy-backs and the SEC reversed them; the states allowed voting discrepancies among shareholders but the stock exchanges under SEC pressure reversed them. For a time the circuit courts were turning fiduciary law into federal law, and while that diminished, some still remains. New securities rules in the 1990s obliterated state parallel law by expressly preempting the state. And Sarbanes-Oxley, reflecting Congressional hunger in 2002 to react to the Enron scandals, mandates a host of corporate governance matters, from the power of the audit committee, to management construction of internal control systems, to the micro-details of loans to managers. All these were once the province of state law.

If states produce good corporate law, we need new theory to explain why. Perhaps that explanation will come from parallels to organizational theory, which recommends separating authority to propose from authority to ratify. Perhaps it will come from a Montesquieu-type separation of powers, checks and balances argument. Perhaps it will come from parallels to the corporation with centralized strategic planners who do not run the operations day-to-day, but who give operating executives a budget limit and who stand ready to take over a lack-luster division's management. It will not come from reconstructing the race-to-the-top theory, which just does not describe what is possible in a functioning federal system. If American corporate law is good in the end, it may well derive from this vertical organizational advantage as much as it derives from competition among the states for the charter business.

But this theoretical angle is only a possibility, not a necessity. More plausibly what we have just done is undermined the last century of corporate law thinking on the interstate race. There cannot be a pure race such as has been posited if there's a Federal system, where the Federal player can take the issue away from the states. We live in such a Federal system. And the possibility is not theoretical, as every corporate crisis—the stuff that tests the quality of corporate law—raises the threat or the actuality of the issue moving from the states to Washington. The idea of a pure race,

comforting as it might have been, is over. We never have had one in the United States. It's just not possible.